IT 96-39
Tax Type: INCOME TAX
Issue: Net Operating Loss (Section 207)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	Docket No.
OF THE STATE OF ILLINOIS,	)	Tax Years Ending6/87 - 6/89
v.	)	FEIN:
TAXPAYER	)	
INC. and AFFILIATES,	)	John E. White,
Taxpayer.	)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Fred O. Marcus, Jordan M. Goodman, and David A. Hughes, of Horwood, Marcus & Braun, Chtrd., Chicago, and Paul H. Frankel, Hollis L. Hyans, and Walter Hellerstein, of Morrison & Foerster, New York, for taxpayer. Deborah Mayer, Special Assistant Attorney General, for Illinois Department of Revenue.

Synopsis:

This matter arose after TAXPAYER and Affiliates, ("TAXPAYER" or "taxpayer") protested a Notice of Deficiency ("NOD") issued by the Illinois Department of Revenue ("Department") on May 5, 1992. The NOD proposed to assess tax, penalties and interest based on the Department's correction of Illinois combined returns taxpayer filed for tax years ending June 30, 1987, June 30, 1988 and June 30, 1989. The Department corrected taxpayer's returns after determining, *inter alia*, that taxpayer should have included certain wholly-owned subsidiaries as members of its unitary business group. TAXPAYER protested the NOD and requested a hearing. TAXPAYER also protested the Department's denial of amended returns TAXPAYER filed to claim refunds for taxes paid for the applicable tax years.

A hearing on TAXPAYER's protests was held at the Department Office of Administrative Hearings on May 18 and 19, and on October 11 through 14, 1994. Chief among the issues presented at hearing were: (1) whether certain of TAXPAYER's subsidiaries were investment companies, required to be excluded from

TAXPAYER's unitary business group; and (2) whether income received by TAXPAYER and its subsidiaries was properly apportioned to Illinois as business income.

At hearing, the parties entered into evidence a stipulation of facts and related exhibits. TAXPAYER presented as witnesses two TAXPAYER officers, an employee of one of its subsidiaries, and two opinion witnesses. The Department presented evidence consisting of TAXPAYER's books and records, and the testimony of the auditor who performed the Department's audit. I have considered the evidence adduced during the course of the hearings, and I am including in this recommendation specific findings of fact and conclusions of law. I recommend that the issues be resolved in favor of the Department, and that the tax and interest proposed in the NOD be assessed.

Findings Of Fact:

Facts Regarding The Department's Audit and the Notice of Deficiency

1. The Department audited TAXPAYER and its affiliates for tax years ending 6/30/87, 6/30/88 and 6/30/89. Stipulation ("Stip.") ¶ 54; Group Ex. P (auditor's workpapers).
2. TAXPAYER filed Illinois income tax returns on a combined basis for the audit period. Stip. ¶ 51.
3. After the audit, the Department issued a Notice of Deficiency ("NOD") to TAXPAYER, which TAXPAYER timely protested. Stip. ¶¶ 55-57; Ex. Q (TAXPAYER's Protest).
4. The NOD proposed to assess tax after making the following audit determinations and/or adjustments to TAXPAYER's filed returns:

   (a). including the following subsidiaries as members of TAXPAYER's unitary business group:

   * TAXPAYER Atlantic, Inc. ("Atlantic");
   * TAXPAYER Central, Inc. ("Central");
   * TAXPAYER East, Inc. ("East");
   * TAXPAYER North America, Inc. ("North America");
   * TAXPAYER Electronic Financial Services, Inc.;
   * TAXPAYER-BIS, Inc.;

   (b). adjusting TAXPAYER's addition modification to include state, municipal, and other interest income excluded from federal taxable

income. TAXPAYER's addition modification was increased because of the increased number of unitary members;

(c). adjusting TAXPAYER's subtraction modification with respect to Internal Revenue Code ("IRC") § 78 Dividend Gross-up, and with respect to foreign dividends. TAXPAYER's subtraction modification was adjusted because of the increased number of unitary members, and because the Department determined that certain dividends claimed to be nonbusiness income should be reclassified as business income;

(d). making various adjustments to TAXPAYER's property, payroll and sales factors;

(e). imposing penalties pursuant to section 1005 of the Illinois Income Tax Act ("IITA").

See Stip. ¶ 55; Stip. Ex. P (Auditor's Comments Section, dated 10/31/91).

5. TAXPAYER Electronic Financial Services, Inc. and TAXPAYER-BIS, Inc. each filed separate Illinois returns for the audit period. *See* Stip. ¶¶ 56-57. The Department determined that the tax paid by those subsidiaries decreased when they were included as members of TAXPAYER's unitary business group (*see* Stip. ¶ 55), and the Department notified TAXPAYER of that determination. *See* Stip. ¶¶ 56-57. TAXPAYER did not protest the Department's determination that TAXPAYER Electronic Financial Services, Inc. and TAXPAYER-BIS, Inc. were members of TAXPAYER's Illinois unitary business group (*see* Ex. Q (TAXPAYER's Protest, p. 2)), and it filed amended Illinois returns to claim a refund of the overpayments the Department determined were made. Stip. ¶ 57. The Department has not made refunds to TAXPAYER based on the subsidiaries' amended returns. Stip. ¶ 57; *see also*, 35 **ILCS** 5/909(a) ("In the case of any overpayment, the Department may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of the tax imposed by this Act . . . .")

6. TAXPAYER filed amended returns for tax years 1987-1989 in which it claimed refunds for interest income it previously reported as apportionable business income, and which it thereafter claimed (in the amended returns) was non-business income. Stip. ¶ 58. The Department denied those claims, and TAXPAYER protested the Department's denials. Stip. ¶¶ 60-61.

Facts Regarding TAXPAYER's Business

7. TAXPAYER is a Delaware corporation which has its commercial domicile in New Jersey. Stip. ¶ 1.

8. TAXPAYER is primarily engaged in the business of providing data processing and related services to customers throughout the United States, including Illinois. Stip. ¶ 2; *see also*, Ex. FF (TAXPAYER's 1987-1989 Annual Reports).

9. During the audit period, TAXPAYER had different operating divisions which provided distinct services to TAXPAYER's customers. Stip. ¶ 2.

10. TAXPAYER's Employer Services Division ("ESD") provided payroll and payroll tax services and unemployment compensation management services to clients from a wide variety of businesses. *Id.*

    (a). ESD provided, *inter alia*, tax filing services for its clients. Transcript ("Tr.") 5/18[1] pp. 22-23 (testimony of WITNESS A ("WITNESS A"), TAXPAYER's current President and Chief Operating Officer, and former Vice-President of Finance and Chief Financial Officer during the audit period).

    (b). When TAXPAYER provided tax filing service, it was responsible for timely filing tax returns and making tax payments for its customers. Tr. 10/13 pp. 496-97 (testimony of WITNESS B ("WITNESS B"), TAXPAYER's Vice-President of treasury operations from 1985 throughout the audit period).

    (c). TAXPAYER's tax filing service was highly volatile. On any given day, TAXPAYER may have had available to use, or would have been required to liquidate, approximately one billion dollars to defray its clients' federal and state liabilities. *See* Tr. 5/18 pp. 157-58 (testimony of Department's auditor, Chris Misthos); Tr. 10/14 pp.

[1]. I will identify citations to the hearing transcript in this matter by including the date of the testimony after the abbreviation "Tr."

603-05 (testimony of WITNESS C ("WITNESS C"), TAXPAYER's current vice-president of corporate tax (*see* Tr. 10/14 pp. 580-81)).

(d). TAXPAYER's tax filing service customers or clients were employers located all over the United States, including Illinois. Stip. ¶ 2.

(e). TAXPAYER's treasury department handled its clients' tax filing service funds. Ex. R (TAXPAYER's Board of Director's Meeting minutes ("TAXPAYER's minutes") for 3/26/87, 5/19/88, 7/23/90); *see also* Stip. ¶ 8.

(f). TAXPAYER described its tax filing service in detail in a request for a private letter ruling from the Internal Revenue Service. *See* Ex. VVV (I.R.S. Priv. Ltr. Rul. 87-29011 *reprinted as* 1987 PRL LEXIS 3003).[2] TAXPAYER's tax filing service functioned in the same manner throughout the audit period. Tr. 5/18 p. 23 (WITNESS A).

(g). TAXPAYER structured its tax filing service to give it the ability to use its clients' funds until TAXPAYER paid the appropriate taxes for those clients. Tr. 10/13 pp. 496-97 (WITNESS B); Tr. 5/18 pp. 157-58 (Misthos).

(h). TAXPAYER realized significant interest income from the operations of its tax filing services division associated with its ability to use its clients tax filing funds. Ex. R (TAXPAYER's minutes for 5/19/88, p. 9 of minutes) (the minutes reflect the following: "WITNESS D [WITNESS D, TAXPAYER's CEO] discussed with the Board the activities

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[2]. TAXPAYER requested a private letter ruling for an opinion regarding whether the float should be considered below-market loans for purposes of section 7872 of the Internal Revenue Code. Ex. VVV at 1. "Float" is the phrase TAXPAYER officers and directors used to describe TAXPAYER's ability to use (or, more accurately, the income realized as a direct result of TAXPAYER's ability to use) its clients' funds that were deposited in TAXPAYER's accounts before they were due to be paid by TAXPAYER to various governmental taxing authorities. *See* Ex. R (TAXPAYER's minutes for 5/19/88, p. 9 of minutes). In the private letter ruling, the IRS determined that although TAXPAYER realized significant interest income from using its clients funds, TAXPAYER showed that such an arrangement did not have a significant effect on the federal tax liabilities of TAXPAYER or its clients. Ex. VVV at 3 (1987 PRL LEXIS **7-8). The IRS ruling was worth approximately $7,000,000.00 (seven million dollars) per year in incremental earnings for TAXPAYER. *See* Ex. R (TAXPAYER's minutes for 5/21/87, p. 3 of minutes).

of Tax Filing Service. He noted that the Company [TAXPAYER] has significant interest income from the float associated with that activity, but it also has certain operating expenses which are offset by the float. However, the extent of the interest income may compel the Company to separately report it at some future time.")

11. TAXPAYER's Dealer Services Division provided computer systems, developed and licensed software, and provided data processing services to manufacturers and dealers of cars, trucks, industrial equipment and related industries. Stip. ¶ 2.

12. TAXPAYER's Accounting Services Division provided automated accounting services to clients in the wholesale distribution industry and to small and mid-size manufacturers. *Id.*

13. TAXPAYER's Network Services Division developed, maintained and provided general and specialized management oriented on-line proprietary programs and data bases to major corporations, financial organizations and governments. *Id.*

14. TAXPAYER's Banking Services Division provided a full range of services to banks and savings and loan associations including accounting services for demand deposits, savings and NOW accounts, installment and commercial loans, mortgage loans, general ledger maintenance and on-line capability to central file information. It also provided automated teller machine ("ATM") services to banks and related institutions. *Id.*

15. TAXPAYER's Dealer Services Division and Employer Services Division are two of TAXPAYER's largest divisions. Stip. ¶ 3.

16. TAXPAYER's Dealer Services Division is headquartered in Illinois, and TAXPAYER personnel provided services for manufacturers and dealers from within Illinois. *Id.*

17. TAXPAYER's Employer Services Division has Illinois sales offices in Chicago, Hoffman Estates and Oakbrook, and has a main facility in Harwood Heights. TAXPAYER's personnel sold and provided payroll and payroll tax

services and unemployment compensation management services from those Illinois locations. *Id.*

18. TAXPAYER divisions and affiliates which also had business operations in Illinois during the audit period included: TAXPAYER Collision Estimating Services, Inc.; TAXPAYER Credit Corp.; TAXPAYER Financial Information Services, Inc.; TAXPAYER Electronic Financial Services, Inc.; and TAXPAYER-BIS, Inc. *Id.*

19. During the audited tax years, TAXPAYER Electronic Financial Services, Inc.; and TAXPAYER-BIS, Inc. were divisions of TAXPAYER, and were not separately incorporated companies. *Id.*

20. During the audited tax years, TAXPAYER's Brokerage Services division (later, TAXPAYER-BIS, Inc, *see* Stip. ¶ 3) provided what TAXPAYER referred to as "front-office" and "back-office" services to its investment and brokerage customers. *See, e.g.*, Ex. FF, 1987 Annual Report, unnumbered exhibit pp. 5 ("Most front-office services are intended to help our clients get more business from their customers, while most back-office services help our clients keep track of the business they already have."), 7 ("In '87, our brokerage industry service, which performs 'back office' order entry, recordkeeping, and inquiry services for more than 350 brokerage clients, had a record year, with a 15% increase in client trading volume.").

21. TAXPAYER received approximately 20-25% of its revenues from its brokerage services division during the audit period. Ex. FF, 1987 Annual Report, unnumbered p. 6 thereof (approximately 25% of revenues); 1988 Annual Report, p. 9 thereof (approximately 25% of revenues); 1989 Annual Report, 8-9 (approximately 20% of revenues).

22. All of TAXPAYER's divisions generated significant amounts of cash. Stip. ¶ 4.

23. TAXPAYER deposited all revenues its divisions received into cash concentration accounts which were part of TAXPAYER's general corporate

account at TRUST ("TRUST") in New York. Stip. ¶ 5; Tr. 5/18 pp. 66-67 (WITNESS A).

24. TAXPAYER funded all of its divisions' operating expenses and disbursements (including, *inter alia*, shareholder dividends, debt repayments, treasury stock repurchases, taxes, etc.) with the revenues deposited through its cash concentration accounts at TRUST. Stip. ¶¶ 5-7.

25. TAXPAYER deposited more than just the revenues received from its operational divisions into TAXPAYER's cash concentration accounts. *See* Tr. 5/18 p. 59 (WITNESS A testified that the revenues TAXPAYER received from convertible debentures were fungible with all TAXPAYER's cash revenues).

26. The revenues TAXPAYER deposited through its cash concentration accounts were fungible, and neither TAXPAYER nor the Department's auditor could trace the daily sources and/or applications of such revenues once they were deposited. *See* Tr. 5/18 p. 59 (WITNESS A); Tr. 10/11 p. 91 (testimony of WITNESS E, a manager in TAXPAYER's outside accounting firm, and TAXPAYER's opinion witness); Tr. 5/18 & 5/19 pp. 151, 229 (Misthos); Tr. 10/12 pp. 386, 400-401 (testimony of WITNESS F ("WITNESS F"), professor of accounting and TAXPAYER's opinion witness); Tr. 10/14 pp. 632-33 (WITNESS C).

26. TAXPAYER collected and invested the cash taken on a daily basis from its various operating divisions, and then dispersed those funds back as needed in its business operations. Tr. 5/18 pp. 66-67 (WITNESS A); *see also*, Ex. HHH (TAXPAYER's Accounting Manual) at 17.

27. TAXPAYER used part of its cash revenues to purchase marketable securities. Stip. ¶ 9.

28. Because a major part of TAXPAYER's regularly conducted business required it to have available up to one billion dollars in cash or cash equivalents on any given day, a regular part of TAXPAYER's treasury department's operations included managing the investment of its available cash reserves. *See* Stip. ¶¶ 9-12; Tr. 10/13 p. 425 (WITNESS B).

Facts Regarding the TAXPAYER's Subsidiaries, Generally

29. Atlantic, East and Central are wholly-owed subsidiaries of TAXPAYER. Stip. ¶ 14. North America is a wholly owned subsidiary of Atlantic. Stip. ¶ 38. Those subsidiaries were Delaware corporations, and none of them filed, nor were they required to file, separate Illinois income tax returns during the audit period. Stip. ¶¶ 14, 53.

30. TAXPAYER capitalized Atlantic, Central, East and North America by contributing cash and/or other properties to those subsidiaries. Stip. ¶¶ 16, 23 (property contributed to Atlantic), 27, 30 (property contributed to East), 34-36 (property contributed to Central), 38-39, 42 (property contributed to North America); Exs. R-V (Board minutes for TAXPAYER, Atlantic, Central, East and North America, respectively); Tr. 5/18 pp. 36-37 (WITNESS A); Tr. 5/18 & 5/19 pp. 142, 149, 153, 155, 157, 224 (Misthos).

31. As a result of TAXPAYER's contributions to its subsidiaries, and for accounting purposes, each of the subsidiaries was able to realize (and report, in federal consolidated returns) substantial streams of income from the transferred properties, while the expenses associated with the properties remained with TAXPAYER, thereby reducing TAXPAYER's Illinois taxable income. *See* Exs. KKK (TAXPAYER's federal 1120 forms and schedules for FYE '87 through '89), MMM (East's federal form 1120 for '86-'89), NNN (Central's federal form 1120 from incorporation through '89), QQQ (Illinois combined 1120 and schedules for FYE '88); SSS (Illinois combined 1120 and schedules for FYE '89); Tr. 5/18 pp. 151-52 (testimony of Misthos regarding loans by Atlantic to TAXPAYER).

32. TAXPAYER exercised strong centralized management authority over the properties it contributed to its subsidiaries, and the income derived therefrom. *See, e.g.*, Tr. 10/13 pp. 538-546 (testimony of WITNESS G ("WITNESS G")).

33. Each subsidiary had two bank accounts at TRUST -- a custodian account and a checking account. The checking accounts were used to receive interest

payments, wire transfers and deposits of maturing investments. Tr. 10/13 p. 446 (WITNESS B).

34. WITNESS H, one of TAXPAYER's corporate vice-presidents, signed or approved checks written to pay the operating expenses of the subsidiaries. Tr. 10/13 p. 547 (WITNESS G); *see also, e.g.*, Exs. PP (checking account records regarding expenses of Atlantic), QQ (checks written by East), RR (checking account records regarding expenses of North America).

35. The expenses reported for Central, East and North America were allocated from Atlantic's expenses, based on the amount of interest income each subsidiary received. Tr. 10/13 p. 512 (WITNESS B).

36. Atlantic, East and North America shared the same office space from July, 1988 through December, 1988. Central shared the same space from September, 1988 through December, 1988. Tr. 10/13 p. 479 (WITNESS B). In December 1988, all the subsidiaries moved to Wilmington Delaware.

37. Of the four subsidiaries, only Atlantic had employees during the audit period. *See* Tr. 10/13 pp. 430 (WITNESS B); Tr. 10/13 p. 532 (WITNESS G).

Facts Regarding Atlantic And The Property To Which It Held Title

38. Atlantic was incorporated in 3/85. Stip. ¶ 16; Ex. S (Atlantic's minutes for 3/7/85).

39. In 3/85, TAXPAYER capitalized Atlantic with $99,000,000.00 (ninety-nine million dollars) in cash and the preferred stock of CORPORATION, valued at $40,000,000.00 (forty million dollars). Stip. ¶ 16. TAXPAYER made subsequent contributions of cash to Atlantic during 3/86, 4/87 and 10/87, in the respective amounts of $148,500,000.00 (one hundred forty-eight million, five hundred thousand dollars), $150,000,000.00 (one hundred fifty million dollars) and $61,500,000.00 (sixty-one million, five hundred thousand dollars). Stip. ¶ 16.

40. Immediately after receiving its initial capitalization from TAXPAYER, Atlantic began making loans to TAXPAYER. *See* Stip. ¶ 17; Ex. TT (Summary of Loans from Atlantic to TAXPAYER).

41. During 10/87, the same month TAXPAYER contributed approximately $150 million to Atlantic, TAXPAYER borrowed $151,100,000.00 from Atlantic. *See* Exs. C-1 through C-3; Ex. S (Atlantic's minutes for 4/3/87); Ex. TT (Summary of Loans from Atlantic to TAXPAYER).

42. Within a week from the date TAXPAYER contributed $61.5 million to Atlantic, TAXPAYER borrowed the same amount from Atlantic. *Compare* Ex. S (Atlantic's minutes for 10/29/87) *with* Exs. C-3 (Department's Summary of Loans from Atlantic to TAXPAYER, p. 3 of exhibit (loan dated 11/5/87)); Ex. TT (TAXPAYER's Summary of loans from Atlantic to TAXPAYER).

43. In the forty-five month period following Atlantic's incorporation (i.e., from 3/85 through 11/88), Atlantic made 51 separate loans to TAXPAYER, which loans totaled over $677,000,000.00 (six hundred seventy-seven million dollars). *See* Ex. C-3. Based on those figures, TAXPAYER, on the average, borrowed in excess of $15,000,000.00 (fifteen million dollars) monthly from Atlantic.

44. Atlantic and TAXPAYER entered into a revolving line of credit agreement on 12/1/88 (Ex. VV), pursuant to which TAXPAYER borrowed money from Atlantic 42 times during the audit period. Ex. C-4.

45. Twelve separate times during the audit period, Atlantic loaned TAXPAYER the money TAXPAYER had agreed to pay Atlantic for prior loans. Ex. C-3 at 2.

46. On its 1987 U.S. 1120, Atlantic reported that it had assets in the amount of $462 million. *See* Ex. LLL. For the same period, Atlantic reported that it had loaned $422 million to TAXPAYER. Ex. TT (TAXPAYER's Summary of loans from Atlantic to TAXPAYER).

47. Until 8/19/86, Atlantic had made intercompany loans to TAXPAYER solely on the oral authority of the board of directors it shared with TAXPAYER. *See* Ex. W (first non-negotiable note prepared by TAXPAYER for 8/22/86 loan); Ex. TT (TAXPAYER's Summary of loans from Atlantic to TAXPAYER).

48. Until 12/88, Atlantic never memorialized any of its intercompany loans to TAXPAYER in a written agreement, and the only instruments documenting

TAXPAYER's unsecured indebtedness to Atlantic were the "Non-negotiable Promissory Notes" which TAXPAYER (the borrower) began to draft in August 1986. *See* Ex. W (Non-negotiable Promissory Notes).

49. Atlantic leased office space in Wilmington, Delaware from May, 1986 through and including December 31, 1988. Ex. KK (copies of leases signed by WITNESS I, then general counsel for TAXPAYER); Tr. 10/13 pp. 479-80 (WITNESS B).

50. From 9/30/86 through 6/30/88, Atlantic had no daily cash investment balance. Ex. ZZZ (TAXPAYER prepared schedule titled, "Daily Cash Investment Balance"). During the same time, Atlantic had a schedule of "marketable securities" of $208 million; on 6/30/88 it had $24 million in marketable securities. Ex. E.

51. TAXPAYER's officers, directors or employees constituted all of Atlantic's officers and Directors. Ex. GGG (list of officers and directors of TAXPAYER, Atlantic, Central, East, and North America ("officers/directors list")).

52. TAXPAYER's officers initiated, ratified, executed and approved all lending activity from Atlantic to TAXPAYER, including drafting and executing the non-negotiable promissory notes and revolving loan agreements, and postponing principal repayments to Atlantic accomplished by WITNESS H (TAXPAYER's Treasurer), and WITNESS J (TAXPAYER's Vice-President of Tax). *See* Ex. S (Atlantic's Board minutes for 3/7/85, 2/6/87 and 4/3/87), Ex. W (TAXPAYER's Promissory Notes); Ex. GGG (officers/directors list); *see also* Ex. C-3; Tr. 5/18 p. 151 (Misthos).

53. On 6/30/89, Atlantic's fixed rate loans to TAXPAYER amounted to $677,544,523.00 (six hundred seventy-seven million, five hundred forty four thousand, five hundred twenty-three dollars) with no "annual repayment". Exs. C-3, TT.

54. TAXPAYER offered no credible evidence closely associated with its regularly maintained books and records (as distinguished from the hearsay reports prepared by others in anticipation for hearing) corroborating its claim

that it did not use the loans from Atlantic in its business operations. While characterizing TAXPAYER's use of the Atlantic loan funds to purchase its treasury stock as an "investment", TAXPAYER's chief operating officer admitted that TAXPAYER used some of the treasury stock purchased as the stock it was required to offer pursuant to TAXPAYER's employee stock purchase plan. Tr. 5/18 pp. 49-50 (WITNESS A).

55. From 12/86 through 10/88, WITNESS K was Atlantic's only employee. Tr. 10/13 pp. 479-480, 510 (WITNESS B).

56. WITNESS K's direct supervisor was WITNESS B, who was employed by TAXPAYER. Tr. 10/13 p. 472 (WITNESS B).

57. WITNESS K was authorized to invest up to $50,000.00 of Atlantic's assets, at a time when Atlantic's total assets amounted to $325,767,000.00 (three hundred twenty million, seven hundred sixty-seven million dollars). *See* Ex. S (Atlantic's minutes of 4/3/87); Tr. 5/18 p. 127 (Misthos).

58. WITNESS K's day-to-day responsibilities for Atlantic included maintaining the books regarding the investment of the subsidiaries' securities portfolios (*see* Tr. 10/13 pp. 472-73 (WITNESS B)), and performing computer work for Atlantic and TAXPAYER's pool treasury operation. Tr. 10/13 pp. 532, 556 (WITNESS G).

59. Only WITNESS H (TAXPAYER's treasurer), WITNESS B (TAXPAYER's treasury department vice president) and WITNESS L (TAXPAYER's comptroller) -- each of whom were also officers of Atlantic -- were the signatories on Atlantic's operating account. Tr. 10/13 p. 549 (WITNESS G); Ex. GGG (officers/directors list).

60. None of Atlantic's employees were signatories on its TRUST accounts during the audit period (*see* Tr. 10/13 pp. 548-49 (WITNESS G)), nor were they permitted or able to authorize the transfer of funds among the TRUST accounts held in the names of East, Central, Atlantic, North America and TAXPAYER. Tr. 10/13 p. 543 (WITNESS G); Ex. FFF (Micro-Cash Connector Agreement); Ex. HHH (TAXPAYER's Accounting Manual, p. 4).

61. Atlantic's trades in various financial instruments were requested and executed either by TAXPAYER's treasury department or by TAXPAYER's outside brokers, and all trades were supervised by TAXPAYER's treasury department. *See* Tr. 10/13 pp. 538-545 (WITNESS G); Tr. 10/13 p. 475 (WITNESS B).

62. WITNESS G purchased only five percent (5%) of Atlantic's investment portfolio. Tr. 10/13 p. 541 (WITNESS G).

63. No Atlantic employee had the authority to "handle" all aspects of investing Atlantic's security portfolio. *Compare* Ex. BBBB, p. 12 (in an answer to a Department interrogatory TAXPAYER responded under oath that, ". . . upon completion of transfer of assets from taxpayer to Atlantic, WITNESS K and WITNESS G handled all aspects of the investment portfolio") *with* Tr. 10/13 pp. 450-51 (WITNESS B describing Atlantic's employees activities regarding the purchases and sales of securities held by Atlantic or the other Delaware companies). That power remained with TAXPAYER's officers and TAXPAYER's treasury department. *See, e.g.*, Tr. 5/18 pp. 39-40 (WITNESS A testified that the ultimate decision-making authority for Atlantic's (and TAXPAYER's other subsidiaries') business activities was held by TAXPAYER's Board of Directors); Tr. 10/13 pp. 419-20 (WITNESS B generally describing TAXPAYER's treasury department and its responsibilities), 449-55 (WITNESS B generally describing his initiation of trades of securities on behalf of TAXPAYER and the Delaware subsidiaries), 481-85 (WITNESS B describing TAXPAYER's treasury department employees' responsibilities regarding TAXPAYER's investments); Tr. 10/13 pp. 536-39 (WITNESS G discussing Atlantic's employees activities regarding the loans from Atlantic to TAXPAYER), p. 541 (WITNESS G discussing TAXPAYER's activities regarding purchases and sales of securities held by Atlantic).

64. Atlantic's employees provided for TAXPAYER the kind of services which TAXPAYER referred to in its books and records as "back-office" services. Tr. 10/13 pp. (WITNESS B describing "back-office" activities of Atlantic's employees); Ex. FF, TAXPAYER's 1987 Annual Report, unnumbered exhibit p. 5

(where TAXPAYER distinguishes between "front-office services" and "back-office" services).

65. Atlantic received the bulk of its income from interest earned from its intercompany loans to its parent, TAXPAYER. Ex. F (TAXPAYER's summary of Atlantic's income).

66. During fiscal year ending ("FYE") 1987, Atlantic received 2.3 million of its total earnings of 3.5 million from interest on loans to TAXPAYER; in FYE 1988, Atlantic earned 51.7 million of its 52 million income from interest on loans to TAXPAYER; and in FYE 1989, Atlantic earned 29 million of its 49.3 million income from interest on loans to TAXPAYER and another TAXPAYER subsidiary. Ex. F (TAXPAYER's summary of Atlantic's income).

67. TAXPAYER exercised strong centralized management authority over the acquisition and disposition of securities Atlantic held, and over all aspects of the loans Atlantic made to TAXPAYER. Tr. 10/13 pp. 536-39 (WITNESS G discussing Atlantic's employees activities regarding the loans from Atlantic to TAXPAYER), pp. 541 (WITNESS G discussing TAXPAYER's activities regarding purchases and sales of securities held by Atlantic).

Facts Regarding Central And The Property To Which It Held Title

68. Central commenced business on 9/2/88. TAXPAYER capitalized Central with $86,392,795.00 (eighty-six million, three hundred ninety-two thousand, seven hundred ninty-five dollars) in marketable securities. Stip. ¶ 34.

69. The securities with which TAXPAYER capitalized Central came from an escrow account TAXPAYER maintained to secure performance under a Master Service Agreement between TAXPAYER-FIS, Inc. and MASTER AGREEMENT ("MASTER AGREEMENT"), wherein that TAXPAYER subsidiary agreed to supply certain services and equipment to MASTER AGREEMENT's client group within and outside the United States. Ex. AA (Master Agreement between TAXPAYER-FIS, Inc. and MASTER AGREEMENT ("Master Agreement"), pp. 1-2, and exhibit 2 thereof (Escrow Agreement)); Tr. 5/18 pp. 64-65 (WITNESS A); Tr. 10/11 pp. 150-153 (WITNESS E); Tr. 10/13 pp. 527-28 (WITNESS B).

74. The escrow account had to be maintained pursuant to the terms of the Master Agreement and through its successful conclusion. Ex. AA (Master Agreement), ex. 2 thereof (Escrow Agreement); Tr. 10/13 p. 528 (WITNESS B).

75. The Escrow Agreement was between TAXPAYER-FIS, Inc., MASTER AGREEMENT, and MASTER AGREEMENT Bank & Trust Co. Ex. AA, ex. 2 (Escrow Agreement, p. 1 thereof). While the Escrow Agreement allowed TAXPAYER-FIS to direct the escrowee to invest the funds TAXPAYER deposited in escrow, all funds TAXPAYER-FIS deposited into escrow were to be immediately available to the escrowee, MASTER AGREEMENT Bank & Trust Co. *Id.*, pp. 2-3.

76. Through its subsidiary's involvement in the Master Agreement, TAXPAYER anticipated becoming the largest U.S. provider of financial quote services. *See* Ex. FF (1988 Annual Report, p. 11 thereof; 1989 Annual Report, pp. 9-10 thereof).

77. In 1989, and as part of its joint venture with MASTER AGREEMENT, TAXPAYER supported 55,000 stock quote terminals for the brokerage and financial community throughout the United States, including Illinois. Ex. FF (1989 Annual Report, p. 10 thereof); Tr. 5/18 pp. 64-65 (WITNESS A).

78. TAXPAYER's officers, directors, or employees constituted all of the officers and directors of Central. Tr. 5/18 p. 93 (Misthos); Exs. R (TAXPAYER's Board minutes), T (Central's minutes), GGG (officers/directors list).

79. Central had no employees. *See* Tr. 10/13 pp. 430 (WITNESS B).

80. No Atlantic employee traded any securities on behalf of Central. Tr. 10/13 pp. 545-546 (WITNESS G).

81. The property to which Central held title and derived income was directly related to the business operations of TAXPAYER-FIS, Inc., a member of TAXPAYER's Illinois unitary business group which conducted business in Illinois. Stip. ¶ 3; Ex. AA (Master Agreement); Tr. 5/18 pp. 64-65 (WITNESS A); Tr. 10/11 pp. 150-153 (WITNESS E); Tr. 10/13 pp. 527-28 (WITNESS B).

Facts Regarding East And The Property To Which It Held Title

82. TAXPAYER made several regular contributions of marketable securities to East during the tax years. Stip. ¶ 27; Ex. I.

83. The securities TAXPAYER contributed to East were purchased with TAXPAYER's tax filing service funds. Ex. R (TAXPAYER's minutes for 3/26/87 & 7/23/90); Ex. U (East's Board minutes of 7/1/88, 9/30/88 & 1/18/89); Tr. 5/18 p. 155 (Misthos); Tr. 10/12 p. 341 (WITNESS F); Tr. 10/13 pp. 494-95 (WITNESS B); Tr. 10/14 pp. 603-05 (WITNESS C).

84. TAXPAYER had contracted with registered investment advisors, such as ADVISORS, to manage a portion of the securities it purchased with the tax filing services funds. *See* Ex. HH (Investment Management Agreement between TAXPAYER and ADVISORS) II (Adjustable Rate Preferred Investment Management Agreement between TAXPAYER and ADVISORS). East was also a party to an investment management agreement for the securities to which it held title. Ex. JJ (Investment Management Agreement between TAXPAYER and MASTER AGREEMENT). TAXPAYER's treasury department supervised ADVISORS's and MASTER AGREEMENT's management of the securities held by TAXPAYER and East. *See* Tr. pp. 10/13 449-55 (WITNESS B).

85. Taxpayer's witnesses arrived at different conclusions based on the same evidence, that is, WITNESS E believed East had no investments (Tr. 10/11 pp. 88-89, 92, 98 (WITNESS E)), WITNESS F and WITNESS C believed East had investments. Tr. 10/12 p. 214 (WITNESS F); Tr. 10/14 p. 609 (WITNESS C).

86. TAXPAYER's officers, directors and employees constituted all of the officers and directors of East. Ex. GGG (officers/directors list); *see also* Tr. 5/18 p. 93 (Misthos); Ex. R (TAXPAYER's minutes); Ex. U (East's minutes).

87. East had no employees. *See* Tr. 10/13 pp. 430 (WITNESS B); Tr. 10/13 p. 530 (WITNESS G).

88. WITNESS B, who was TAXPAYER's vice-president of treasury operations during the audit period, initiated, conducted, ratified and approved East's activities, and held two offices for East. Ex. U (East's Board minutes for

11/4/88, 1/18/89, 5/4/89, 7/27/89); Tr. 10/13 pp. 419-20 (WITNESS B generally describing TAXPAYER's treasury department and its responsibilities), 449-55 (WITNESS B generally describing his initiation of trades of securities on behalf of TAXPAYER and the Delaware subsidiaries), 481-85 (WITNESS B describing TAXPAYER's treasury department employees' responsibilities regarding TAXPAYER's investments), 450-51 (WITNESS B describing the "back office" activities of Atlantic's employees).

89. Fifty Percent (50%) of the marketable securities to which East held title were managed by ADVISORS and supervised by TAXPAYER's treasury department, five percent (5%) by Atlantic's employee WITNESS G, and the remaining forty-five percent (45%) by TAXPAYER's officers or employees (e.g., WITNESS B) in TAXPAYER's treasury department. Tr. 10/13 pp. 449-55 (WITNESS B); Tr. 10/13 pp. 540-41 (WITNESS G).

90. The portfolio of marketable securities to which East held title was managed by TAXPAYER's treasury department consistent with TAXPAYER's policy regarding the investment of its operational funds. *See* Ex. EEE.

91. The salary expense of $21,841.00 which East reported on its U.S. 1120 for fiscal year ending 6/30/89 (*see* Ex. MMM), was not directly incurred by it, but was allocated to East by Atlantic, based on its relative investment income. *See* Tr. 10/13 p. 430-32 (WITNESS B).

92. For tax year ending 6/30/89, the securities to which East held title generated interest income in excess of $23 million. Tr. 5/18 p. 155 (Misthos); Exs. KKK (TAXPAYER's consolidated form 1120), MMM (East's form 1120).

93. By excluding East from its Illinois unitary business group, TAXPAYER also excluded the interest income earned from its management of the securities to which East held title. Tr. 5/18 p. 155 (Misthos); Exs. KKK (TAXPAYER's consolidated form 1120), SSS (TAXPAYER's combined IL-1120 for 6/30/89).

94. The securities to which East held title and derived income were directly related to the operations of TAXPAYER's tax filing services division, which

division conducted business in Illinois. Tr. 10/14 pp. 602-04 (WITNESS C); *see also*, Stip. ¶ 3. As a regular part of its operational function to TAXPAYER, TAXPAYER's treasury department managed and supervised the purchase, trading, and other dispositions of East's portfolio of securities. Tr. 10/13 pp. 449-55 (WITNESS B).

Facts Regarding North America and the Property to Which it Held Title

95. TAXPAYER researched, developed and used its trademarks in the ordinary course of its data processing business operations. Ex. R (TAXPAYER's minutes for 8/17/88); Ex. S (Atlantic's minutes); Ex. V (Trademark Assignment dated 7/1/88).

96. Prior to July 1988, TAXPAYER and its affiliates used TAXPAYER's trademarks without charge. Stip. ¶¶ 16 & 41; Tr. 10/13 p. 546 (WITNESS G).

97. In July, 1988, TAXPAYER assigned its trademarks to Atlantic, who then assigned the trademarks to North America. Stip. ¶¶ 38-40; Tr. 5/18 pp. 157-158 (Misthos); Tr. 10/13 p. 544 (WITNESS G).

98. The TAXPAYER trademarks were used by the businesses TAXPAYER conducted in Illinois. *See* Stip. ¶ 41.

99. TAXPAYER requested and received a Touche Ross (now DeLoitte Touche) accounting study suggesting royalty rates to be charged for its trademarks. Tr. 10/13 pp. 437, 525-26 (WITNESS B); Tr. 10/13 p. 547 (WITNESS G); Ex. V (North America's Board minutes for 7/29/89); Ex. PP (check number 2028, dated 4/5/89 for $500.00 for study of Touche Ross on "Delaware Holding Companies" addressed to WITNESS J head of taxpayer's Tax Department); Tr. 5/18 p. 47 (WITNESS A).

100. After the Touche Ross study was completed, TAXPAYER began to charge itself and its subsidiaries royalties for the use of the TAXPAYER trademarks, which royalties TAXPAYER calculated as a percentage of gross revenues. Tr. 10/13 p. 436 (WITNESS B); *see also* Ex. DD.

101. No written license agreements were in effect between North America and TAXPAYER during the audit period, or between North America and the other

TAXPAYER affiliates being charged for the right to use the TAXPAYER trademarks in their business. *See* Stip ¶ 16; Ex. DD; Tr. 5/18 pp. 159 (Misthos); Tr. 10/13 pp. 524-25 (WITNESS B); Tr. 10/13 pp. 546 (WITNESS G); Ex. V (North America Board minutes for 11/4/88).

102. North America was first named as a party to a written license agreement regarding the TAXPAYER trademarks in October 1, 1990. Ex. EEEE.

103. TAXPAYER increased the royalty rate to be collected by North America after the audit period, but the increase was applied retroactively, resulting in $17.8 million in additional royalty fees to TAXPAYER and its subsidiaries. Ex. DD; Tr. 10/13 p. 546 (WITNESS G).

104. TAXPAYER's officers, directors, or employees constituted all of the officers and directors of North America. Ex. GGG (officers/directors list); *see also* Ex. V (North America's Board minutes for 11/4/88, 1/18/89, 5/4/89, 7/27/89).

105. North America had no employees. *See* Tr. 10/13 p. 430 (WITNESS B).

106. TAXPAYER's treasury department staff continued to manage the assets it transferred to North America by writing the license agreements, and imposing the royalty fees to be paid by TAXPAYER affiliates. *Id.*; *see also*, Tr. 10/13 pp. 524-25 (WITNESS B); Tr. 10/13 p. 546 (WITNESS G).

107. The salary expense of $47,269.00 which North America reported on its U.S. 1120 for fiscal year ending 6/30/89 (*see* Ex. NNN), was not directly incurred by it, but was allocated to it by Atlantic, based on its relative investment income. *See* Tr. 10/13 p. 430-32 (WITNESS B).

108. North America's combined income for 6/30/89 was $65,972,224.00. Ex. NNN (North America's federal form 1120).

109. North America paid $21,615,056.00 in dividends to Atlantic during their 1989 tax year. Stip. ¶ 46; Ex. V (North America's Board minutes for 1/18/89 & 7/29/89); Ex. NNN (North America's federal form 1120); Tr. 10/13 p. 436 (WITNESS B).

110. The dividends North America paid to TAXPAYER, and North America's entire income, were directly related to TAXPAYER's management of property held by North America, which property was managed by TAXPAYER and regularly used by TAXPAYER and its subsidiaries in their day-to-day business operations, including those operations conducted in Illinois.

Facts Regarding Atlantic's, Central's, East's and North America's Status as Investment Companies

111. During a prior audit of TAXPAYER's business for tax years ending 6/30/85 and 6/30/86, Department audit staff made a determination that Atlantic was a financial organization, to wit: an investment company. *See* Stip. ¶ 62-63.

112. Pursuant to that prior determination, Department audit staff "corrected" TAXPAYER's Illinois combined returns, in which TAXPAYER had included Atlantic as part of TAXPAYER's unitary business group (and in which TAXPAYER treated Atlantic's income as non-business income), by directing TAXPAYER to exclude Atlantic from TAXPAYER's Illinois combined return filed for its unitary business group. Stip. ¶¶ 64, 65; *see also* Petitioner's Initial Brief ("TAXPAYER's Brief"), at 8-9 & nn. 5 & 6.

113. Until the Department made a determination that Atlantic was an investment company during a prior audit, TAXPAYER had not claimed that Atlantic was an investment company. Stip. ¶¶ 64-65.

114. Atlantic, Central, East and North America were never registered with the Securities and Exchange Commission as investment companies pursuant to the Investment Company Act of 1940. *See* Tr. 10/12 p. 250 (WITNESS F).

115. There was no credible evidence introduced at hearing showing that Atlantic, Central, East or North America were investment companies as that term is defined in section 3 of the Investment Company Act of 1940.

116. There was no evidence admitted which purported to show that Atlantic, Central East or North America ever proposed to issue securities to the public.

117. The only securities Atlantic, Central and East issued were their own stock, and TAXPAYER owned all such securities. Ex. LLL (TAXPAYER's consolidated federal tax return and schedules for tax year ending 6/30/89) (unnumbered p. 72 of exhibit ("Form 851, Part II")); *see also* Stip. ¶ 14; 15 U.S.C. §§ 80a-2(22) (definition of "issuer"), 80a-2(36) (definition of "security"). The only securities issued by North America was its own stock, and Atlantic owned all such securities. *See* Stip. ¶ 38.

118. TAXPAYER introduced no evidence showing that Atlantic, Central, East or North America were "regulated investment companies", as that term is used in the IITA, which were subject to tax imposed by section 852 of the Internal Revenue Code ("IRC"). *See* 35 **ILCS** 5/203(e)(2)(D) (1994) (*formerly* Ill. Rev. Stat. ch. 120, ¶ 2-203(e)(2)(C) (1969)).

119. The activities of TAXPAYER's Atlantic, Central, East and North America subsidiaries involved holding title to the assets contributed by TAXPAYER and the income realized therefrom, and allowing TAXPAYER or its subsidiaries the use of the assets or values associated therewith, as directed by TAXPAYER. Those activities, all of which were strictly controlled by TAXPAYER officers or employees, do not constitute a separate line of business in which each subsidiary engaged which was independent of, or discrete from, the business operations of TAXPAYER. Instead they constitute an integral part of TAXPAYER's management of the operational funds TAXPAYER received from the diverse business operations conducted by TAXPAYER's unitary business, including the business conducted in Illinois.

120. Atlantic, Central, East and North America were not members of the investment company industry, and they were not investment companies, as that term is used in the Illinois Income Tax Act's ("IITA") definition of a financial organization. 35 **ILCS** 5/1501(a)(8).

Conclusions of Law:

Issue 1

The first issue is whether Atlantic, East and Central are "investment companies", as that term is used in section 1501(a)(8) of the Illinois Income Tax Act ("IITA").

In its Brief, counsel for Department argues that I need not consider whether TAXPAYER's subsidiaries are investment companies (and therefore, financial organizations), because those subsidiaries were merely an extension of TAXPAYER's treasury department. Department Brief, p. 25. I disagree. The Department's auditor made a determination that Atlantic, East, Central and North America were not investment companies. Stip. Ex. P (Auditor's Comments, pp. 9-12). He also determined that the subsidiaries should be included in TAXPAYER's unitary business group. *Id.*, pp. 3-9. TAXPAYER disputes those determinations. Quite clearly, whether the Department's determinations are correct are facts at issue in this matter.

More importantly, section 1501(a)(27) of the IITA provides in part that, "[i]n no event . . . will any unitary business group include members which are ordinarily required to apportion income under different subsections of Section 304 . . . ." 35 **ILCS** 5/1501(a)(27). TAXPAYER filed combined returns apportioning its unitary business group's business income pursuant to section 304(a). Financial organizations, including investment companies, apportion their business income pursuant to section 304(c) of the IITA. Therefore, the question whether TAXPAYER's subsidiaries are investment companies must be addressed here. If they are, the Department is precluded, under the clear terms of the IITA, from combining them with the other members of TAXPAYER's unitary business group. 35 **ILCS** 5/1501(a)(27).

The IITA includes the term "investment company" in the Act's definition of a financial organization. 35 **ILCS** 5/1501(a)(8). Section 1501(a)(8) of the IITA provides:

> Financial Organization. The term "financial organization" means any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency

> exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company. For the purpose of this Section a "person" will include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956 (12 U.S.C. 1841, et seq.), except where interests in any person must be disposed of within certain required time limits under the Bank Holding Company Act of 1956.

35 **ILCS** 5/1501(a)(8). None of the organizations enumerated in the definition of a financial organization were defined.

At the close of the Department's case-in-chief, counsel for TAXPAYER argued that the definition of an investment company contained in the Investment Company Act of 1940 ("Investment Company Act"), 15 U.S.C. 80a-3, should be used when determining whether the TAXPAYER subsidiaries are investment companies. *See* Tr. pp. 249-50; *but see* TAXPAYER's Brief, pp. 29-34 (arguing that the appropriate definition should be guided by "standards" identified in four Department ruling letters). The Department has also stated in the past that the Investment Company Act's definition is applicable when considering whether a corporation is an investment company under § 1501(a)(8) of the IITA. *See* Exhibit MMMM (copy of 17 Ill. Reg. 13216, 13217 (issue 32, August 6, 1993)). For the following reasons, I agree that the statutory definition contained in the Investment Company Act is a definition to consider when determining whether TAXPAYER's subsidiaries are investment companies.

The legislature found it unnecessary to define any of the organizations enumerated in § 1501(a)(8) because the terms had, at the time, commonly understood meanings within the respective financial industries. The statutory definition of financial organizations must be read in context. Illinois Power Co. v. Mahin, 49 Ill. App. 3d 713, 716 (4th Dist. 1977) (text of a statute must always be read in context). When the legislature used the phrase "investment company" in section 1501(a)(8), they used the term in a provision in which they were identifying the only entities ordinarily allowed to use the single factor apportionment method to calculate business income. Like all the other types of entities enumerated in the provision, the term "investment company" was used to

identify a particular type of financial organization which had already been defined, and subjected to regulation, pursuant to the respective state and/or federal statutes and regulations applicable to each member of the enumerated financial industries.

For example, when the legislature enacted section 1501(a)(8) of the IITA, a "bank" had already been defined pursuant to the Illinois Banking Act, Ill. Rev. Stat. ch. 16½, ¶ 102 (1969), and pursuant to various federal banking acts, e.g., the National Banking Act, 12 U.S.C. § 21 *et seq.* (1969), and the Federal Deposit Insurance Corporation Act, 12 U.S.C. § 1813 (1969); a "bank holding company" had already been defined pursuant to the Illinois Bank Holding Company Act of 1957, Ill. Rev. Stat. ch. 16½, ¶ 72 (1969), and pursuant to the Bank Holding Company Act of 1956, 12 U.S.C. § 1841 *et seq.* (1969); a "trust company" had already been defined pursuant to the Illinois Banking Act, Ill. Rev. Stat. ch. 16½, ¶ 101 *et seq*. (1969)); and a "currency exchange" had already been defined pursuant to Illinois' Currency Exchange Act, Ill. Rev. Stat. ch. 16½, ¶ 31 *et seq*. (1969). And when the legislature enacted section 1501(a)(8) of the IITA, an "investment company" had already been defined pursuant to the Investment Company Act. 15 U.S.C. § 80a-3.

At least one state Supreme Court has acknowledged that the term "investment company" is a term of art. In Bureau of Employment Security v. Hecker & Co., the Pennsylvania Supreme Court wrote:

> [t]he term "investment company" is a term of art and refers to companies, such as mutual fund companies, whose business is to make a profit by investing in other companies. It is so defined in the Investment Company Act, [footnote omitted] in the Pennsylvania Business Corporation Law, as well as in other Pennsylvania statutes. **In the absence of evidence to the contrary, we must assume that the legislature intended to use the term in this accepted business sense.**

409 Pa. 117, 124, 185 A.2d 549, 553 (1962) (emphasis added). Similarly, when the Illinois general assembly used the term "investment company" in the IITA, it had recently defined the identical term in another Illinois statute. *See*, Ill. Rev. Stat. ch. 21, ¶ 64.2 ("An act to amend . . . the 'Cemetery Care Act'")

(Laws 1967, p. 1189, eff. July 7, 1967) (*now codified at* 760 **ILCS** 100/2). In a 1967 amendment to the Cemetery Care Act, the legislature defined "investment company", in part, as a company "defined in and registered under the 'Investment Company Act of 1940' . . . ."[3] While the Cemetery Care Act is obviously not *in pari materia* with the IITA, the legislature's prior definition of the same term by specific reference to the definition in the Investment Company Act is strong evidence that the legislature accepted the Investment Company Act's definition as authoritative.

Pursuant to the Investment Company Act, an "investment company" means:

> any issuer which
>
> (1) is or holds itself out as being primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
>
> (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
>
> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.

15 U.S.C. § 80a-3(a).

The statutory definition, however, does not end there. Sections 80a-3(b) and (c) of the Investment Company Act specifically detail the characteristics of those organizations which are excepted from the definition of an investment company. 15 U.S.C. §§ 80a-§§ 3(b)-(c). Although neither party addressed the statutory exceptions from the definition of an investment company, it is

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[3]. The applicable amendment to the Cemetery Act's definition section provided:

> "Investment Company" means any issuer (a) whose securities are purchasable only with care funds or trust funds, or both; and (b) which is an open and diversified management company as defined in and registered under the "Investment Company Act of 1940"; and (c) which has entered into an agreement with the Auditor containing such provisions as the Auditor by regulation reasonable requires for the proper administration of the Act.

Ill. Rev. Stat. ch. 21, ¶ 64.2 (1967).

fundamental that related parts of a statute be read together, and not isolated or taken out of context. *See, e.g.*, Antunes v. Sookhakitch, 146 Ill. 2d 477, 588 N.E.2d 1111, 1114 (1992); Kraft v. Edgar, 138 Ill. 2d 178, 561 N.E.2d 656, 661 (1990).

Section 80a-3(b) of the Investment Company Act provides:

> (b) Notwithstanding subsection (a) of this section, **none of the following persons is an investment company** within the meaning of this subchapter:
>
> (1) Any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.
>
> (2) Any issuer which the Commission, upon application by such issuer, finds and declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses. The filing of an application under this paragraph in good faith by an issuer other than a registered investment company shall exempt the applicant for a period of sixty days from all provisions of this subchapter applicable to investment companies as such. For cause shown, the Commission by order may extend such period of exemption for an additional period or periods. Whenever the Commission, upon its own motion or upon application, finds that the circumstances which gave rise to the issuance of an order granting an application under this paragraph no longer exist, the Commission shall by order revoke such order.
>
> (3) Any issuer all the outstanding securities of which (other than short term paper and director's qualifying shares) are directly or indirectly owned by a company excepted from the definition of investment company by paragraph (1) or (2) of this subsection.

15 U.S.C. § 80a-3(b) (emphasis added).

Subsection (c) of the statutory definition provides, in part:

> (c) Notwithstanding subsection (a) of this section, **none of the following persons is an investment company** within the meaning of this subchapter:
>
> (1) Any issuer whose outstanding securities (other than short term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. For purposes of this paragraph:

> (A) Beneficial ownership by a company shall be deemed to be beneficial ownership by one person . . . .

15 U.S.C. § 80a-3(c) (emphasis added). The subsidiaries are clearly excepted from the definition of an investment company pursuant to §§ 80a-3(b)(3) and 80a-3(c)(1).

Unlike some of the other financial industries represented by the organizations enumerated in § 1501(a)(8) of the IITA, there is no Illinois counterpart to the Investment Company Act, most probably because that federal act was intended to establish a comprehensive scheme applicable to all investment companies. *See, e.g.*, Herpich v. Wallace, 430 F.2d 792, 814 (5th Cir. 1970) ("The technique of the Act", the Fifth Circuit Court wrote, "is to require registration with the SEC of all investment companies that use the mails or interstate facilities, with registration serving as the handle for the regulatory scheme."). Pursuant to § 80a-7 of the Investment Company Act, if an entity meets the definition of an investment company, it cannot conduct business in interstate commerce without first being registered with the SEC. 15 U.S.C. § 80a-7; SEC v. Fifth Avenue Coach Lines, Inc., 289 F.Supp. 3, 41 (S.D.N.Y. 1968) ("Section 7 of the Act provides in substance that no investment company, unless it is registered, shall use the means and instrumentalities of interstate commerce to buy or sell securities . . . ."), *aff'd*, 435 F.2d 510, 512 (3d Cir. 1970) ("[The District Court] found Fifth to be . . . an investment company which, because it had not registered under the 1940 Act, was acting in violation of § 7(a) of the Act").

While certain organizations are exempted from the provisions of the Investment Company Act pursuant to § 80a-6, no credible evidence was introduced showing that the subsidiaries at issue were subject to the exemptions detailed in that section of the Act. Absent such evidence, TAXPAYER's argument that I should consider its subsidiaries investment companies, even though they are not registered with the SEC, is not persuasive. Registration with the SEC is one of the primary indicia of a member of the investment company industry. Even

TAXPAYER's own opinion witness acknowledged that the subsidiaries could not be registered under the Investment Company Act because they did not meet the statutory definition. Tr. 10/12 p. 354 (WITNESS F).[4]

The other definition to consider when determining whether TAXPAYER's subsidiaries are investment companies is the definition of a "regulated investment company." At the time the General Assembly enacted the IITA, it included therein statutory provisions setting forth with particularity the manner by which certain entities were to report their base federal income. Ill. Rev. Stat. ch. 120, ¶ 2-2-203 (1969) (*now* 35 **ILCS** 5/2-203 (1994)). One of the entities the legislature specifically identified in those provisions was "regulated investment companies." Ill. Rev. Stat. ch. 120, ¶ 2-2-203(d)(2)(C) (1969)) (*now* 35 **ILCS** 5/2-203(d)(2)(C) (1994)). That section of the IITA provides:

> (2) Special Rule. For purposes of paragraph (1) of this subsection, the taxable income properly reportable for federal income tax purposes shall mean:

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[4]. See also, e.g., the following responses contained in no-action letters issued by the SEC. In response to the question, "Can a corporation with only fifteen stockholders register under the Investment Company Act of 1940?", the SEC responded:

> **Not unless at the time of its registration it proposes to make a public offering of its securities.** The reason for this is that Section 3(c)(1) of the Act excludes from the definition of investment company "[any] issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." **To permit voluntary registration for tax reasons would contravene the plain wording of the section.**
>
> **Moreover, as a matter of administrative policy we do not favor registration under the Act where the sole or predominant purpose is to obtain a tax advantage for a limited number of private investors.**

In re George E. Mrosek, 1973 NO-ACT. LEXIS 3783 (January 7, 1973) (emphasis added).

In another no-action letter the SEC wrote:

> . . . Section 3(c)(3) of the Act, however, excepts "any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." **If your client comes within this exception, registration under the Act would not be necessary or permissible**.

In re Theodore Harris, 1979 NO-ACT. LEXIS 2656 (March 1, 1979) (emphasis added).

* * *

> (C) Regulated investment companies. In the case of a regulated investment company subject to the tax imposed by section 852 of the Internal Revenue Code, [footnote omitted] investment company taxable income.

35 **ILCS** 5/2-203(d)(2)(C) (1994).

A regulated investment company is defined in section 851 of the Internal Revenue Code ("IRC"). 26 U.S.C. § 851. Section 851 provides, in part:

> (a) General rule. For purposes of this subtitle, the term "regulated investment company" means any domestic corporation -
>
> (1) which, at all times during the taxable year -
>
> (A) is registered under the Investment Company Act of 1940, as amended [citation omitted] as a management company or unit investment trust, **or**
>
> (B) has in effect an election under such Act to be treated as a business development company, **or**
>
> (2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act from the definition of "investment company" and is not included in the definition of "common trust fund" by section 854(a) [of the IRC].
>
> (b) Limitations. **A corporation shall not be considered a regulated investment company for any taxable year unless-**
>
> (1) **it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year**;

26 U.S.C. § 851 (emphasis added). "Investment company taxable income" is defined in 26 U.S.C. § 852(b)(2).

The universe of regulated investment companies as defined by IRC § 851 clearly includes more members than does the universe of investment companies as defined by § 80a-3 of the Investment Company Act. I read the different sections of the IITA which relate to the investment company industry together. The inference logically drawn from the General Assembly's specific direction that regulated investment companies use "investment company taxable income" as their federal base income is that the legislature recognized regulated investment companies as members of the investment company industry. Thus, I conclude that the General Assembly intended that a regulated investment company be included in the term "investment company" within § 1501(a)(8) of the IITA.

Whether an entity is one of the financial organizations enumerated in section 1501 (a)(8) of the IITA is a fact question which must be determined on a

case-by-case basis. Any factual determination need not be particularly difficult or burdensome, however, as this case plainly reveals. Proof that an entity is one of the financial organizations enumerated in section 1501(a)(8) of the IITA would ordinarily be made by introducing evidence that the entity is, in fact, a member of the particular financial industry in which it purports to engage, and that it is actually engaged in the business claimed.

The facts relevant to the first issue in this matter are not in dispute. TAXPAYER's witness WITNESS F testified clearly and unequivocally that neither Atlantic, Central, nor East were registered as investment companies with the SEC during the tax years audited. Tr. 10/12 p. 250. WITNESS F's testimony on this point was offered by TAXPAYER, during direct examination. TAXPAYER never asserted that North America was registered as an investment company with the SEC, nor did TAXPAYER ever assert or establish that any of its subsidiaries were exempted from registration with the SEC pursuant to section 80a-6 of the Investment Company Act. Finally, TAXPAYER never claimed that any of its subsidiaries were regulated investment companies. It never offered any evidence that any of the subsidiaries ever filed an election with the SEC to be treated as a business development company pursuant to IRC § 851(a)(1)(B), or with the IRS pursuant to IRC § 851(a)(2). TAXPAYER simply failed to show that its subsidiaries were, in fact, members of the investment company industry.

TAXPAYER's witnesses' opinions have no persuasive effect on the facts regarding each subsidiaries' organization, structure, activities, and ultimately, investment company status. For example, WITNESS F's opinion that the subsidiaries' activities were essentially similar to the activities engaged in by companies that are required to be registered under the Investment Company Act (*see, e.g.*, Ex. CCCCC; TAXPAYER's Brief, p. 39) is not evidence which tended to establish that the subsidiaries were members of the investment company industry. Comparisons may well be drawn and similarities identified between the activities of the financial organizations enumerated in § 1501(a)(8) of the IITA and the activities of other businesses not enumerated therein. A pawnshop,

however, cannot prove that it is a "bank" under § 1501(a)(8) of the IITA by offering an opinion witness' testimony that the pawnshop's collateralized loans to individuals were essentially similar to loans made by companies regulated under either the Federal Deposit Insurance Corporation Act or the Illinois Banking Act.

WITNESS F's opinions that TAXPAYER's subsidiaries were investment companies, and that they were also investment companies not required to register with the SEC, were offered without any factual foundation, and no facts of record support such conclusions. For example, WITNESS F himself testified that the subsidiaries could not be registered as investment companies with the SEC because they did not meet the definition contained in the Investment Company Act. *See* Tr. 10/12 p. 354. Additionally, none of the subsidiaries proposed to offer securities to the public,[5] and none of the subsidiaries filed elections to be treated as regulated investment companies. Finally, WITNESS F admitted that his definition of an investment company had never been adopted by any regulatory or other entity. Tr. 10/12 pp. 321-22.

I also found WITNESS F's opinions regarding whether the subsidiaries' activities were "investments" irrelevant to the question whether TAXPAYER's subsidiaries were actually members of the investment company industry. In fact, even TAXPAYER's other opinion witness could not agree with WITNESS F's opinion that Atlantic's loans to TAXPAYER were investments. Tr. 10/11 p. 142 (WITNESS E testified that the loans were not investments). WITNESS E also testified that

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[5]. In an applicable annotation in the American Law Reports, the author states:

> an investment company is an entity which invests in securities on behalf of its investors or shareholders for the purpose of capital appreciation, income preservation or safety of capital, or for a combination of such purposes **and, in furtherance of this objective, the investment company sells its own securities to the public** and then reinvests the proceeds in a portfolio of securities which it manages on a continuous basis.

David J. Oliveiri, Annotation, *What is an "Investment Company" Under § 3 of the Investment Company Act of 1940 (15 USCS § 80a-3)*, 64 A.L.R. Fed. 337, 341 (emphasis added).

Because the subsidiaries did not issue securities to the public, they did not engage in activities typically characteristic of investment companies.

East had no investments. Tr. 10/11 pp. 88-89, 92, 98 (WITNESS E). If every company which "invested in things" (*see* Tr. 5/18 p. 15 (TAXPAYER's opening statements)) were to be considered an investment company -- especially given WITNESS F's opinion of what acts constitute "investments" -- single-factor apportionment would be the rule in Illinois and three-factor apportionment the exception. I don't believe the General Assembly intended such a result when it specifically identified the organizations allowed to use the single-factor apportionment method. Thus, I gave little if any weight to WITNESS F's opinions when determining the subsidiaries' status as investment companies. *See* Maercker Point Villas Condo. Assoc. v. Szymski, 275 Ill. App. 3d 481, 486, 655 N.E.2d 1192, 1195 (3d Dist. 1995) ("The weight to be assigned an expert's opinion depends on the factual basis for that opinion, as an expert's opinion is only as valid as the reasons for it.") (*quoting* In re Winters, 255 Ill. App. 3d 605, 609 (1994)).

While counsel for TAXPAYER paid lip service to the statutory definition contained in the Investment Company Act at hearing, the real focus of TAXPAYER's argument that Atlantic, Central, East and North America are investment companies lay elsewhere. TAXPAYER argues that I must recognize its subsidiaries as investment companies because Department employees had previously interpreted the term "investment company" to include companies such as, or similar to, its subsidiaries. *See* TAXPAYER's Brief, pp. 29-32. TAXPAYER supports that argument by citing to four private letter rulings ("PLR(s)") issued by the Department between 1989 and 1990 (*see* Exs. IIII (PLR 89-0034), JJJJ (PLR 89-0110), KKKK (PLR 90-0067), LLLL (PLR 90-0218)), and claims that those ruling letters are the only indication of Department policy regarding its interpretation of the definition of an investment company during the years at issue. *Id.*, pp. 33-34 n.19; *but see* PLR 87-0085 (April 8, 1987) (in that Department ruling letter issued during the audit period, the writer tied the definition of an investment company as used in § 1501(a)(8) of the IITA to the definition of a regulated investment company, pursuant to IRC § 851). TAXPAYER argues, in effect, that

the Department should be estopped from asserting in this matter an interpretation of section 1501(a)(8) of the IITA which differs from the ones expressed in ruling letters issued to others.

The fundamental problem with TAXPAYER's argument that its subsidiaries are investment companies, or that they should be deemed to be investment companies, is that Department is the only entity to whom TAXPAYER claims that its subsidiaries are investment companies. That, no doubt, is because the Department was the only entity which informed TAXPAYER during a prior audit period that it considered TAXPAYER's Atlantic subsidiary to be an investment company. TAXPAYER's corporate financial history proving that it is not a company that ignores financial opportunities when presented, once the Department directed TAXPAYER to exclude that subsidiary -- and its considerable income -- from its Illinois combined returns, TAXPAYER proceeded to form other corporate subsidiaries and contribute large amounts of income-producing assets to them, while continuing to manage and use the assets, or values associated therewith, in its business operations.

Members of the investment company industry provide investment services to the public, which is why they are so heavily regulated. The TAXPAYER subsidiaries, however, never took the steps required to be taken by members of the investment company industry. That was, I conclude, no accident. TAXPAYER is not exactly a corporate novice. When TAXPAYER formed the subsidiaries whose income is at issue here, the Investment Company Act of 1940 had been in existence for decades. The IRC, similarly, had defined regulated investment companies since at least 1957. It is impossible for me to believe that TAXPAYER ignored, or was unaware of, the provisions of those federal statutes. TAXPAYER's counsel's argument that ruling letters written by the Department's employees provide the only public standard governing investment companies is ludicrous. *See* TAXPAYER's Reply Brief, p. 16. I conclude that TAXPAYER never intended that the subsidiaries be members of the investment company industry.

As to the effect of the Department's prior audit determination that Atlantic was an investment company, the general rule is that "[t]he State is not estopped by the mistakes made or misinformation given by the Department's employees with respect to tax liabilities." Brown's Furniture, Inc. v. Wagner, Docket No. 78195, slip op. at 18, (Illinois Supreme Court, April 18, 1996) (*citing* Austin Liquor Mart v. Department of Revenue, 51 Ill. 2d 1, 5, 280 N.E.2d 437, 439 (1972)). Moreover, three of the letter rulings on which TAXPAYER purports[6] to rely were revoked by the Department almost a year before hearing. *See* Ex. MMMM (published August 6, 1993). Finally, only the taxpayer requesting a Department ruling letter may seek to estop the Department from collecting tax not remitted due to the taxpayer's reliance on unsound advice given in a ruling letter later revoked by the Department. 20 **ILCS** 2520/4 (*formerly* Ill. Rev. Stat. ch. 120, ¶ 2304 (1991) (Taxpayer's Bill of Rights)); 86 Ill. Admin. Code § 9800(b) (1987) (Binding Effect of Letter Rulings); 2 Ill. Admin. Code § 1200.110(d) (1993) (Private Letter Rulings).

The proper interpretation of a statute is a question of law. The Union Electric opinion, relied on by TAXPAYER (*see* TAXPAYER's Brief, p. 33), involves the Illinois Supreme Court's review of the Department's interpretation of one of its regulations. *See* Union Electric v. Department of Revenue, 136 Ill. 2d 385, 395-96 (1990). The letter rulings on which TAXPAYER claims reliance render legal opinions on a question of statutory -- not regulatory -- interpretation. While an agencies' interpretation of the statute it administers is entitled to deference, if the interpretation is erroneous, it cannot be entertained. *See,*

[6]. Not only was there no evidence that TAXPAYER actually relied on the letter rulings to which its attorneys now cite, there was no evidence introduced which showed that TAXPAYER ever had knowledge of the letter rulings during the audited tax years. For example, WITNESS C, TAXPAYER's V.P. of Tax, testified that TAXPAYER relied on a prior audit determination that Atlantic was an financial organization prior to forming Central, East and North America. *See* Tr. 10/14 pp. 597-601. TAXPAYER never claimed that Atlantic was an investment company until the Department informed it that the Department considered Atlantic to be an investment company. Finally, the subsidiaries were incorporated before some of the letter rulings on which TAXPAYER purports to have relied were issued.

e.g., Flex v. Department of Labor, 125 Ill. App. 3d 1021, 1024, 466 N.E.2d 1050, 1053 (1st Dist. 1989).

This matter has facts similar to those in United Air Lines v. Mahin, 49 Ill. 2d 45, 49 (1971), *aff'd*, 410 U.S. 623 (1973). In that case, United Air Lines sought to prevent the Department from assessing use tax on fuel loaded onto taxpayer's aircraft in Illinois. The basis for United Air Line's complaint was that the Department had begun to assess tax on all fuel loaded onto its aircraft in Illinois. The Department had previously taxed only a portion of the fuel loaded into United Air Line's aircraft, referred to as the "burn-off amount", because the Department had long interpreted the Use Tax Act's definition of "use" as granting the Department the authority to tax only that portion of fuel consumed (i.e., "burned off") in Illinois airspace.

The Department subsequently revised its interpretation of the Use Tax Act's provision, and published that interpretation in an Information Bulletin, much in the same manner as was the Department's published revocation of the rulings letters on which TAXPAYER purports to rely here. In United Air Lines, the Illinois Supreme Court upheld the Department's ability to revise its interpretation of the statute, and denied taxpayer's attempt to bind the Department to its prior interpretation of the term. Fundamental to the Court's decision was its understanding that the Department's prior interpretation of the statute did not comport with law. While the tax act involved in this matter is different, the logic and public policy considerations underlying the Supreme Court's decision in United Air Lines are similarly applicable here.

It would not be reasonable to accept as sound administrative law or policy the proposition that a State agency should be precluded from acting consistent with the law as written because its officers, agents, or employees previously made erroneous statements -- oral or written -- about the effect of the law to other persons. The law, in fact, is directly to the contrary. Brown's Furniture, Inc. v. Wagner, Docket No. 78195, slip op. at 18 (Illinois Supreme

Court, April 18, 1996). Certainly the legislature did not provide for such a result when it passed Illinois' Taxpayer's Bill of Rights.

Nor would fundamental justice be served in this particular matter by requiring the Department to be bound by its prior audit determination involving TAXPAYER. The evidence adduced after a full hearing clearly established that neither Atlantic nor TAXPAYER's other subsidiaries performed the acts by which they could have brought themselves within the statutory definitions of an investment company or a regulated investment company, and, thereby, made themselves members of the investment company industry. The Department should not be required to recognize TAXPAYER's subsidiaries as being investment companies when the subsidiaries themselves have not attempted to achieve such status. The Department's prior audit determination to the contrary was clearly wrong, and justice would not be served by requiring that it be repeated. I conclude that the Department cannot be estopped from making the determination, for this audit period, that Atlantic, Central, East and North America were not investment companies.

Issue 2

The second issue is whether the Department properly apportioned the income of TAXPAYER and its subsidiaries. The determination of this second issue involves two separate steps: determining whether TAXPAYER and its subsidiaries were engaged in a unitary business; and, if they were, determining whether the income the Department proposed to assess was properly apportioned as business income. The Department's auditor made both such determinations. *See* Ex. P (Auditor's Comments). Those determinations are entitled to a *prima facie* presumption of correctness. 35 **ILCS** 5/904.

The IITA provides a definition of "unitary business group." A unitary business group is:

> a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. . . . . Unitary business can ordinarily be illustrated where the activities of the

> members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either case, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member).

35 **ILCS** 1501(a)(27) (1994) (*formerly* Ill. Rev. Stat. ch. 120, ¶ 15-1501(a)(28) (1985)).

The auditor extensively detailed in his audit comments the bases for his determination that TAXPAYER and its subsidiaries were engaged in a unitary business enterprise. Stip. Ex. P (Auditor's Comments Section, dated 10/31/91). The auditor's report cites to the specific entries in TAXPAYER's or its subsidiaries' books and records upon which he relied when making his unitary determination. That audit report was introduced at hearing, as were the books and records regularly maintained by TAXPAYER and/or its subsidiaries, upon which the auditor relied when making his unitary determination.

After its formation, and during prior audit periods, TAXPAYER had included Atlantic as a member of its Illinois unitary group, but had characterized Atlantic's income as non-business income. Similarly, the TAXPAYER subsidiaries which filed separate returns for the tax years at issue (i.e., TAXPAYER Electronic Financial Services, Inc. and TAXPAYER-BIS, Inc., *see* Stip. ¶¶ 56-57) did not complain when the Department included them as members of TAXPAYER's unitary business group. *See* Ex. Q (TAXPAYER's Protest). TAXPAYER's, and its subsidiaries', books and records corroborate the auditor's unitary determination, as does the testimony of TAXPAYER's fact witnesses, who confirmed that all activities of the subsidiaries were conducted under the strong centralized management by TAXPAYER's officers, directors and treasury department employees.

TAXPAYER failed to introduce credible evidence closely identified with its books and records establishing that the Department's unitary determination was

incorrect. TAXPAYER offered conclusory testimony, opinion testimony, and written hearsay reports and opinions to support its argument that its subsidiaries were engaged in businesses which were unrelated to the businesses TAXPAYER conducted in Illinois. *See, e.g.*, TAXPAYER's Brief, pp. 40-45. Those written reports and schedules were prepared in anticipation for hearing, and do not carry with them the evidentiary reliability of TAXPAYER's regularly maintained books and records.

Most importantly, the factual bases upon which TAXPAYER's witnesses' premised their opinions and conclusions were never proved by credible and objective evidence. For example, throughout this matter, TAXPAYER has asserted that the income earned from the property it contributed to its subsidiaries was never used by TAXPAYER in its business operations. *See, e.g.*, TAXPAYER's Brief, p. 3. That conclusion was asserted in opinions rendered by TAXPAYER's accounting firm, by WITNESS F, when he analyzed TAXPAYER's subsidiaries' activities, and by WITNESS E, when he prepared schedules of the apportionment methods offered by TAXPAYER. *See* Tr. 10/11 pp. 90-95 (WITNESS E).

At the heart of the conclusion TAXPAYER asserts to be true was its acceptance of a definition for the phrase "excess cash." *See, e.g.*, Tr. 10/11 pp. 90-95 (WITNESS E). That definition, however, in no way accounts for TAXPAYER's actual day-to-day use of the cash deposited into its bank accounts by Atlantic, Central and North America. WITNESS E, in fact, acknowledged TAXPAYER's inability to provide evidence of its claim, because it commingled its operational and investment income in its cash accounts. As WITNESS E testified at hearing:

> . . . I guess in an ideal world, if the investment income was deposited into an investment account, if somehow you could go back and segregate that at the beginning and deposit all the investment income in an investment account, and all the operating income in an operating account, you know, it would be pretty simple.
>
> But companies, businesses don't operate that way. It all goes into one cash account, because it's a very important thing for a company to be able to have hands-on control, and be able to deal with concentrated banks. So it all goes in one cash account.

Tr. 10/11 p. 95. So, while WITNESS E or WITNESS C were able to account for those amounts of cash which exceeded TAXPAYER's anticipated or actual expenditures at the end of the year or some other period, when WITNESS E rendered his ultimate conclusion that the subsidiaries income was unrelated to the unitary business group's business in Illinois, he merely accepted as true the assumption that TAXPAYER did not need, and would not use, the securities purchased with its "excess cash", or the income derived therefrom. *See* Tr. 10/12 pp. 139-40, 142 (WITNESS E).

WITNESS F, TAXPAYER's other opinion witness, also acknowledged that it would be impossible to ascertain with any degree of certainty how TAXPAYER used its cash revenues from day-to-day. *See* Tr. 10/12 pp. 400-01 (WITNESS F). Both WITNESS E and WITNESS F merely accepted as true the assumption that TAXPAYER did not need the cash or other assets it contributed to its subsidiaries when they reached their respective conclusions in this matter. Both also admitted that the fact presumed could not be shown to be true. Because the witnesses agreed that a fundamental factual premise upon which they based their conclusions could not be proved, their conclusions are not reliable.

Similarly, WITNESS E's conclusion that TAXPAYER's treasury staff and Atlantic's employees have nothing to do with TAXPAYER's business in Illinois (*see* Tr. 10/11 p. 104-05), is not corroborated by the facts adduced at hearing. WITNESS E did not know that Atlantic acquired the securities through a contribution from TAXPAYER (*see* Tr. 10/11 pp. 159-60), and his only knowledge of the activities of Atlantic's employees was based on conversations he had with TAXPAYER executives. *Id.*, pp. 155-58. TAXPAYER's treasury department staff and officers are employees of the parent and controlling member of the Illinois unitary group. Those employees initiated, supervised and otherwise controlled the purchases and trades of the securities to which Atlantic, Central, East and North America held title. While TAXPAYER maintained that the subsidiaries' employees "handled" the investments of the securities to which they held title (*see* TAXPAYER's Reply, p. 6 ("investment employees handled their trades")), that

argument is not borne out by the facts. Atlantic was the only subsidiary with employees, and those employees primarily performed the required recordkeeping functions regarding the transfers of securities which TAXPAYER's treasury department initiated, managed or otherwise approved. *See* Tr. 10/13 pp. 449-55 (WITNESS B generally describing his initiation of trades of securities on behalf of TAXPAYER and the Delaware subsidiaries, and the "back office" activities of Atlantic's employees); Ex. FF, TAXPAYER's 1987 Annual Report, unnumbered exhibit p. 5 (describing "back-office" services as, "help[ing] [companies] keep track of the business they already have"). WITNESS E's conclusions on this point are similarly unreliable.

Moreover, the facts established by the evidence introduced at hearing make it reasonable to infer that TAXPAYER did use income derived from the assets to which its subsidiaries held title in TAXPAYER's business operations. For example, WITNESS E testified that the dividends TAXPAYER received from the subsidiaries were deposited into cash accounts from which, TAXPAYER stipulates, it funded all operational expenses and disbursements. *See* Stip. ¶¶ 6 & 7. Without using segregated accounts for the investment income TAXPAYER realized through its management and investment of the securities to which its subsidiaries held title, and with its own witnesses testifying that the funds deposited into its cash accounts were fungible with the operational funds also deposited therein, there are no reliable documentary bases in the record for TAXPAYER's claim.

Directly contrary to TAXPAYER's claim, the inference to be drawn from TAXPAYER's regular and frequent loans from Atlantic is that TAXPAYER borrowed money from Atlantic because, after making contributions of considerable amounts of cash or cash equivalents to Atlantic, it needed the money. *See, e.g.*, Tr. 10/14 pp. 629-31 (WITNESS C testifying that TAXPAYER immediately borrowed from Atlantic the amount it contributed to Atlantic). On several occasions, Atlantic loaned TAXPAYER the money TAXPAYER was supposed to pay Atlantic for prior loans. *See, e.g.*, Ex. C-3 (Department's Summary of Loans from Atlantic to TAXPAYER, p.

2 of exhibit (Loans to TAXPAYER used to pay outstanding loan balance)). The inference to be drawn from TAXPAYER's loans from Peter to pay Peter is that TAXPAYER needed the funds to meet its operational needs. Without some credible corroborative evidence, I cannot accept as true TAXPAYER's mere testimonial assertion that it borrowed over $650,000,000.00 from Atlantic during the course of the audit period (*see* Ex. TT (TAXPAYER's Summary of loans from Atlantic to TAXPAYER)), without needing the money, and without using the loan proceeds in its business operations.

Even more significantly, TAXPAYER's chief operating officer testified that TAXPAYER used the loans it took from Atlantic to purchase treasury stock. While characterizing such purchases as an investment, WITNESS A later admitted that TAXPAYER used some of the treasury stock it bought with the loan funds to satisfy its contractual obligation make stock available for its employee stock purchase program. Tr. 5/18 pp. 49-50 (WITNESS A). WITNESS A's conclusory testimony regarding his characterization of the subsidiaries' activities as investments, like WITNESS F's opinion testimony, is not the kind of objective evidence which shows that TAXPAYER actually treated the transactions involving the assets it contributed to its subsidiaries as investments, instead of as part of its business operations.

The United States Supreme Court's decision in Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 112 S.Ct. 2251, 119 L.Ed. 2d 533 (1992), provides that a determination whether an intangible asset serves an operational or investment function must involve a consideration of *objective* evidence regarding the actual use of the asset and the income derived therefrom, and not merely evidence regarding the taxpayer's intent when acquiring, managing, or disposing of the asset. There, the Supreme Court wrote:

> We may assume, arguendo, that the managers of Bendix cared most about the profits entry on a financial statement, but that state of mind sheds little light on the question whether in pursuing maximum profits they treated particular assets as serving, on the one hand, an investment function, or, on the other, an operational function. [citation omitted] **That is the relevant**

> **unitary business inquiry, one which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State.**

Allied Signal, 504 U.S. at 784-85, 112 S.Ct. at 2262, 119 L.Ed. 2d at 550 (emphasis added). WITNESS A's mere testimony that TAXPAYER's contribution of assets to its subsidiaries was intended to serve an investment function pales when compared to the evidence that the assets were related to the business operations of TAXPAYER's unitary group, including those operations carried on in Illinois, and that the income derived from, or values associated with, the assets were regularly used by TAXPAYER in its business operations.

TAXPAYER, through its separate divisions, is primarily engaged in the business of providing data processing services to clients throughout the United States. Stip. ¶ 2. The scope and nature of the data processing services vary depending on the different types of customers. *See id.* One of TAXPAYER's largest divisions was its tax filing service, which service was provided to employers from all over the United States, including Illinois. As part of that service, TAXPAYER was given huge amounts of cash which were deposited into TAXPAYER's accounts, and then turned over to governmental taxing authorities. *See, e.g.*, Tr. 10/13 pp. 496-97 (WITNESS B) (TAXPAYER structured its tax filing service to give it the ability to use its clients' funds until TAXPAYER paid the appropriate taxes for those clients); Tr. 10/14 pp. 603-05 (WITNESS C testified that TAXPAYER could either receive or be required to turn over up to a billion dollars in a single day as part of its tax filing service).

Developing the most productive means of handling the large amounts of cash TAXPAYER received from, or used in, its business operations was clearly a functionally integrated part of TAXPAYER's business operations, and that function was handled by TAXPAYER's treasury department. *See* Stip. ¶¶ 9-12. TAXPAYER's purchases and management of securities acquired with income derived from its data processing services was not a separate line of business TAXPAYER conducted. Rather, those activities, conducted by TAXPAYER's treasury department, were functionally integrated with the operations of TAXPAYER's

unitary business enterprise. *See* 35 **ILCS** 1501(a)(27); 86 Ill. Admin. Code § 10.9700(g) (1990) (*formerly* 86 Ill. Admin. Code § 10.9900(g) (1987)); 86 Ill. Admin. Code § 10.9700(h)(5) (1990) (*formerly* 86 Ill. Admin. Code § 10.9900(h)(5) (1987)).

During the course of its business, TAXPAYER's treasury department regularly purchased marketable securities with the income TAXPAYER received from its operations. TAXPAYER purchased marketable securities in order to obtain a profit from the large amount of cash its business operations produced. *See, e.g.*, Tr. 10/13 pp. 496-97 (WITNESS B). It deposited the income realized from purchasing the securities into the same cash accounts into which it deposited the income from its data processing services, and into which it deposited cash from other sources.

The activities of TAXPAYER's Atlantic, Central, East and North America subsidiaries involved holding title to the assets contributed by TAXPAYER and the income realized therefrom, and allowing TAXPAYER or its subsidiaries the use of the assets or values associated therewith, as directed by TAXPAYER. Those activities did not constitute a separate "business" conducted by the subsidiaries. The subsidiaries did not provide investment services to the public, just as they did not provide investment services to TAXPAYER. TAXPAYER's treasury department and other TAXPAYER officers, directors or employees were the active managers of the assets held by TAXPAYER's subsidiaries. TAXPAYER's treasury department also directed the activities of East's outside investment advisors. Those activities were not discrete from, or unrelated to, TAXPAYER's unitary business operations. The assets from which the income the Department proposes to tax in this matter were acquired with income received from the business operations of TAXPAYER's unitary business, including the business operations conducted in Illinois, and TAXPAYER, the parent of Illinois' unitary business group, exercised actual control and management over those assets.

For example, Atlantic held title to marketable securities which TAXPAYER thereafter used to fund regular inter-company loans to TAXPAYER. TAXPAYER employees, however, wrote the Notes to Atlantic, dictated the loan terms, rates, and effectuated the actual transfer of the loan funds. The "handling" performed by Atlantic's employees involved, basically, recording the trades, and recording fund transfers associated with the investments managed or supervised by TAXPAYER's treasury department. *See, e.g.*, Tr. 10/13 pp. 476-77 (WITNESS B); Tr. 10/13 pp. 538-45 (WITNESS G). Central held marketable securities and funds relating to TAXPAYER-FIS, Inc's joint venture with MASTER AGREEMENT. TAXPAYER, however, set the investment policy regarding the actual investment of the funds and assets to which Central (and all the other subsidiaries) held title. TAXPAYER initiated, supervised, and/or approved the trades. East held securities purchased with TAXPAYER's tax filing services funds, which securities TAXPAYER regularly contributed to East. TAXPAYER, however, hired and supervised the investment advisors who handled the day-to-day management of 50% of the securities to which East held title, and TAXPAYER's officers and/or treasury staff managed the majority of the remaining percentage of securities. North America held title to the TAXPAYER trademarks which TAXPAYER, and all of its affiliates, regularly used in their business operations. TAXPAYER, however, hired the consultants who proposed the royalty rates which TAXPAYER later imposed when, eventually, it wrote the licenses pursuant to which the royalty payments were documented.

WITNESS G and WITNESS B, TAXPAYER's witnesses, confirmed that TAXPAYER initiated and/or supervised trades of the securities held by the subsidiaries. They also confirmed that the loans to TAXPAYER from Atlantic were, when eventually put into writing, written by the borrower, not the lender, and that only TAXPAYER employees, officers, or TAXPAYER's treasury department staff had the authority to wire loan funds from the lender to the borrower. The borrower/parent, therefore, dictated the amount, terms and rates for the loans given by the lender/subsidiary. Similarly, TAXPAYER told North America what

North America was going to charge for the royalties for the use of the TAXPAYER trademarks. "Arms-length" is not the correct adjective to use when describing such transactions, regardless of the interest or other rates charged. *See* TAXPAYER's Brief, p. 11.

I make no conclusions regarding the Department's argument that TAXPAYER's incorporation of its subsidiaries was a sham, because such conclusions are not necessary. The correctness of the Department's audit determinations was established by the overwhelming evidence that TAXPAYER and its included subsidiaries were members of a single unitary business group, and by objective evidence that the income of the members TAXPAYER excluded from the group was income derived from TAXPAYER's management of "a group of assets . . . used by the same overall entity for the generation of income through operation of a single unitary business." Citizens Utility v. Department of Revenue, 111 Ill. 2d 32, 39-40, 488 N.E.2d 984, 986-87 (1986).

By separately incorporating subsidiaries and contributing to them large amounts of income-producing assets, TAXPAYER set up a means by which it could arguably support, through the separate accounting method, a sizable reduction in its reported income by attributing large amounts of income to the purported "business" of the subsidiaries. Ex. EEEEE (TAXPAYER's tax filings in other states). In some states, some variation of the separate accounting method may still be accepted as an appropriate means of determining apportionable business income for state tax purposes.

The Illinois General Assembly and the Illinois Supreme Court, however, have eschewed separate accounting as the appropriate means for determining the apportionable income of an integrated group of corporations doing business in many states. While perhaps not mere "shell" corporations, TAXPAYER's arguments that its subsidiaries' distinct corporate form must be recognized to the extent that income alleged to be derived solely from the subsidiaries' activities be attributable to their domiciliary state, ring hollow. I recognize the separate corporate existence of TAXPAYER's subsidiaries. TAXPAYER, however, should also

recognize that its subsidiaries activities are functionally integrated with the operations of its unitary business operations.

The Department's detailed description of how TAXPAYER reduced its reported Illinois income, while continuing to enjoy both the use of, and the income derived from, the assets in its unitary business operations, vividly illustrates Justice Simon's observations regarding why formula apportionment is preferable to separate accounting:

> "Separate accounting is a geographically oriented method which is analytically suited to the case of a single taxable entity carrying on separate and distinct businesses in each taxing district. In such cases apportionment is accomplished simply by reporting to each State the separate and identifiable earnings of the distinct business enterprises in the State. A more complex method is called for when the single entity carries on an integrated business in several States with the operation in each jurisdiction contributing to the income of all other operations through centralized management, accumulated know-how and economies of scale. **Income earned from these types of businesses, commonly referred to as unitary businesses, cannot be accurately apportioned by use of separate accounting since that method does not take account of each operation's contribution to the income of the business as a whole; it is also subject to manipulation by shifting income to States with more favorable tax climates.** [citations omitted] . . . .
>
> When a unitary business is carried on by an associated group of corporate entities, commonly referred to as a "unitary business group," resort to formula apportionment is also in order; a group of assets is used by the same overall entity for the generation of income through operation of a single unitary business. **If corporate forms were respected, State income taxation would be as artificially limited and open to manipulation as is the method of separate accounting.** . . .

Citizens Utility v. Department of Revenue, 111 Ill. 2d 32, 39-40, 488 N.E.2d 984, 986-87 (1986) (emphasis added).

I have already concluded that TAXPAYER and its subsidiaries were members of a unitary business group; I now conclude, additionally, that the Department properly apportioned the subsidiaries' income as business income. Section 1501(a)(1) of the Illinois Income Tax Act defines business income, in pertinent part, as follows:

> The term 'business income' means income arising from transactions and activities in the regular course of the taxpayer's trade or business. . . and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations . . . .

35 **ILCS** 5/1501(a)(1). Nonbusiness income is defined as "all income other than business income or compensation." 35 **ILCS** 5/1501(a)(13). The Department's regulations additionally provide, in part:

> A person's income is business income unless clearly classifiable as nonbusiness income. . . Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of trade or business operations. Accordingly, the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business. **In general, all transactions and activity which are dependent upon or contribute to the operations of the economic enterprise as a whole will be transactions and activity arising in the regular course of a trade or business.**

86 Ill. Admin. Code § 100.3010(a) (emphasis added).

The IITA's statutory definition of business income establishes two separate and distinct tests by which income can be classified as business income: the transactional test and the functional test. Dover Corporation v. Department of Revenue, 271 Ill. App. 3d 700, 711-12, 648 N.E.2d 1089, 1097. If either test is met, the income is properly classified as business income. *Id.*

The transactional test is derived from the first clause of section 1501(a)(1) (transactions and activity in the regular course of the taxpayer's trade or business). Under the transactional test, income is business income if derived from a type of business transaction in which the taxpayer regularly engages. The functional test is derived from the second clause of section 1501(a)(1) (income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations). Under the functional test, the relevant inquiry is whether the property was used in the taxpayer's regular

trade or business operations. Dover, 271 Ill. App. at 711-12, 648 N.E.2d at 1097.

Here, either test is satisfied for the income received by TAXPAYER and its subsidiaries from securities purchased with TAXPAYER's operational funds and managed by TAXPAYER's treasury department. *See* Exs. B, F, J, L & N; Tr. 10/14 pp. 581-85 (WITNESS C). The transactional test is satisfied because the subsidiaries' income was earned as a direct result of the regular transactions and operations TAXPAYER undertook regarding the assets TAXPAYER contributed to each subsidiary. As a regular part of TAXPAYER's business operations, its treasury department managed and supervised the acquisition and disposition of securities purchased by TAXPAYER and contributed to each subsidiary. TAXPAYER's management of those securities, as well as those securities it held in its own name, was a regular and integral part of TAXPAYER's business operations.

The income each subsidiary derived from its holding of those securities was, in large part, returned to TAXPAYER in the form of loans and/or dividends, or was otherwise used by TAXPAYER during the regular course of its unitary business operations. TAXPAYER deposited the loan or dividend amounts into the cash concentration accounts into which TAXPAYER deposited all other operational revenues, and TAXPAYER used those cash concentration accounts to fund the regular expenses associated with its unitary business operations. The income earned by Atlantic, Central and East was, therefore, earned through transactions in which TAXPAYER regularly engaged.

The income also satisfies the functional test. The assets from which the income was derived was acquired, in part, from the unitary business group's business operations in Illinois. While the source of funds used to purchase securities may not have anything to do with a determination of whether the entity holding title to the securities is an investment company (*see* TAXPAYER's Brief, p. 36), it is relevant when determining whether income derived from such securities is apportionable to Illinois, under the functional test. *See* Dover, 271 Ill. App. 3d at 712, 648 N.E.2d at 1096-97 (*quoting* 86 Ill. Admin Code §

100.3050(a)). The actual management of the assets from which the income was derived was performed by the treasury department staff and/or officers of TAXPAYER, the parent of the Illinois unitary business group. TAXPAYER's management of its securities, and of the securities to which its subsidiaries held title, included identifying the securities to be purchased and/or traded.

The interest income TAXPAYER paid Atlantic is similarly business income apportionable to Illinois under either the transactional or functional test. The marketable securities contributed to Atlantic by TAXPAYER were used to fund loans to TAXPAYER almost from the date Atlantic was formed. TAXPAYER, in fact, often borrowed from Atlantic the amount of TAXPAYER's scheduled payments to Atlantic for outstanding loans. TAXPAYER deposited the loan proceeds into its cash accounts, and the inference reasonably drawn from such commingling of funds is that the funds deposited were to be used in the regular business operations. No regularly maintained books and records were ever introduced into evidence supporting TAXPAYER's bare assertion that it used the $677,000,000.00 in loans from Atlantic solely to purchase treasury stock (*see* TAXPAYER's Reply Brief, p. 15).

Even if such documentary evidence were introduced, however, TAXPAYER's president testified that TAXPAYER used some of the treasury stock purchased with the Atlantic loan monies to fulfill its obligation to offer stock to its employees. Tr. 5/18 pp. 49-50 (WITNESS A). Such testimony belies WITNESS A's characterization of TAXPAYER's purchases of treasury stock as an "investment." The objective evidence shows that TAXPAYER used the loans from Atlantic for its regular business operations.

The income Atlantic received from interest charged to its parent was the single greatest source of Atlantic's total income during the tax years audited. Atlantic's loans to TAXPAYER were regular transactions in which it engaged, and, I conclude, the loans were integral to, and part of TAXPAYER's regular business operations. The regular intercompany loans from Atlantic to its parent represented a constant flow of value, and economies of scale, available to

TAXPAYER. *See, e.g.*, Ex. BBBB, XXXXX & A.WITNESS F, *"Finance Subsidiaries: Their Formation and Consolidation"* 13 J. of Bus. Fin. & Accounting 137, 137 (on page 1 of exhibit, WITNESS F wrote, "for appropriate levels of inventories and receivables, the formation of finance subsidiaries may provide significant operating and financing economies of scale."). The regular flow of value Atlantic contributed to TAXPAYER was not in any way eliminated because of the interest rate charged for the loans. *See* 86 Ill. Admin. Code § 100.9700(6).

The income of North America, including the dividend paid to TAXPAYER, was also business income. TAXPAYER, the parent of the Illinois unitary business group, regularly performed all the acts by which the trademarks to which North America held title were licensed, and the royalties received. By contributing its trademarks to North America, and then imposing on itself royalties for the use thereof, all TAXPAYER did was to create for itself and its affiliated companies a business expense where none had existed before. TAXPAYER, therefore, continuously used the values associated with the trademarks from which North America derived income in the normal course of its business operations, including those business operations conducted in Illinois.

In this case, TAXPAYER had the burden of demonstrating that the income on which the Department proposed to assess tax was nonbusiness income. TAXPAYER offered mere opinion and other testimony that such income was unrelated to TAXPAYER's business activities in Illinois, and mere argument that the Department didn't prove that the income was business income. I do not accept as true TAXPAYER's witnesses' conclusory testimony that TAXPAYER treated the assets it contributed to its subsidiaries as serving an investment function. The documentary and other objective evidence adduced at hearing established that: (1) the assets producing the income on which tax was proposed were acquired from TAXPAYER's unitary business operations, including those operations conducted in Illinois; and (2) values associated with those assets were regularly used in and by TAXPAYER's unitary business. The evidence offered by TAXPAYER was insufficient to rebut the *prima facie* correctness of the Department's

determination, reflected by the NOD, that the income at issue was business income apportionable to Illinois. *See* Balla v. Department of Revenue, 96 Ill. App. 3d 293 (4th Dist. 1981).

Issue 3

After the close of the Department's case-in-chief, TAXPAYER moved, *inter alia*, to abate the § 1005 penalties proposed in the NOD. *See* 35 **ILCS** 5/1005 (penalties for underpayment of tax). The administrative law judge ("ALJ") who conducted the hearing granted TAXPAYER's motion to abate the § 1005 penalties. *See* Order dated 6/29/94. The basis for the ALJ's decision is clear: TAXPAYER filed its returns to exclude Atlantic Central, East and North America from its Illinois combined returns because the Department, during a prior audit, told it to exclude Atlantic from its combined returns. Because the record contains evidence of TAXPAYER's reasonable cause, I recommend that the Director abate the § 1005 penalties proposed to be assessed.

Conclusion To Part 1 of Recommended Decision

I recommend that the tax and interest proposed in the Notice of Deficiency be assessed. The section 1005 penalties proposed should be abated because the facts support the ALJ's implied finding that TAXPAYER had reasonable cause for excluding the subsidiaries from its Illinois combined returns. The amended returns filed by TAXPAYER Electronic Financial Services, Inc. and TAXPAYER-BIS, Inc. should be granted, and the amounts the subsidiaries overpaid applied to reduce TAXPAYER's deficiency. TAXPAYER's amended return should be denied because the income claimed to be nonbusiness income was business income. The NOD should be finalized as set forth in this recommended decision.

Part 2 of Recommended Decision

In its protest, TAXPAYER requested, pursuant to 35 **ILCS** 5/304(f) of the IITA, that the Department consider alternative methods of apportioning the income proposed to be taxed. *See* Ex. Q (TAXPAYER's Protest), p. 15. At hearing, TAXPAYER offered into evidence schedules prepared in anticipation of hearing, and opinion and other testimony, that alternative apportionment methods be considered in this matter. *See, e.g.*, Exs. RRRR (2/1/94 "American Home Products" letter from Deloitte & Touche to WITNESS C); TTTT (Source of excess cash flowchart); UUUU (proposed alternative apportionment Formula I, "American Home Products" bargraph); VVVV (Formula II, "Most significant business expenditure" bargraph). TAXPAYER also requested that the value of the securities held by TAXPAYER and its subsidiaries be included in the denominator of the property factor. *See* Ex. SSSS (2/1/94 "factor representation" letter from Deloitte & Touche to WITNESS C). I recommend that the Director deny TAXPAYER's request for alternative apportionment.

TAXPAYER's witness WITNESS E prepared exhibits and testified as a witness regarding the alternative apportionment formulas proposed by TAXPAYER. WITNESS E testified that when preparing his reports, he accepted as true the assumption that the properties TAXPAYER contributed to the subsidiaries were not needed by TAXPAYER, and that the income derived from those properties would not be used by

TAXPAYER during the course of its business. *See e.g.*, Tr. 10/11 pp. 95, 139 (WITNESS E). WITNESS E also assumed that TAXPAYER's purchase of treasury stock was an investment, although WITNESS A, TAXPAYER's president and chief operating officer, testified that TAXPAYER used some of the treasury stock purchased as the stock used in its employee stock purchase program. I have already concluded that the assets TAXPAYER contributed to its subsidiaries, including values associated therewith (e.g., loans, dividends, use of deposited funds to obtain favorable bank rates and/or services), were used by TAXPAYER in its business operations. The assumptions WITNESS E accepted as true make unreliable his estimates of business income apportionable to Illinois.

With regard to TAXPAYER's factor representation proposal, TAXPAYER presented no persuasive argument why the value of the securities held by the subsidiaries should be included in the denominator of the property factor. The property factor includes:

> real and tangible personal property owned or rented by such person and used during the tax period in the regular course of such trade or business. The term "real and tangible personal property" includes land, building, [sic] machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency.

86 Ill. Admin. Code § 100.3350(a)(1981). Here, TAXPAYER's own witness viewed the securities TAXPAYER contributed to its subsidiaries as being the functional equivalent of cash. *See e.g.*, Tr. 10/12 pp. 201, 237-38, 333 (WITNESS F). As the equivalent of cash, such intangible property would not be included in the property factor.

TAXPAYER's reliance upon Crocker Equipment Leasing Inc. v. Department of Revenue, 314 Ore. 122, 833 P.2d 55 (1992), is misplaced because the facts in that matter are distinct from those presented by this matter. In that case, the taxpayer, Crocker Equipment Leasing Inc. ("CELI") was a wholly owned subsidiary of Crocker National Bank ("Crocker"), in turn a subsidiary of a bank holding company registered under the Bank Holding Company Act of 1956. Crocker and its parent were both, in fact, engaged in the business of banking. Like Illinois,

the Oregon Department of Revenue recognized a regulated bank holding company as a species of financial organization, which organizations were allowed to apportion business income in a manner different from the three-factor apportionment method.

The critical difference between the facts in Crocker and the facts in this matter is that in Crocker, the company whose income the Oregon Supreme Court allowed to be apportioned differently was, in fact, a member of a regulated financial industry which was actually engaged in a business distinct from that of its subsidiary. The Oregon Supreme Court also noted that financial organizations were, under the provisions of the Uniform Division of Income for Tax Purposes Act, which provisions the State of Oregon had incorporated by statute, allowed to include the amounts of intangible assets in the property factor. Crocker, 314 Ore. at 127, 133. Crocker, in effect, stands for the proposition that when a non-domiciliary financial organization is unitary with a non-financial organization doing business in the taxing state, different apportionment methods may be appropriate to prevent a disproportionate representation of the financial organizations' income attributable to the taxing state. *See* Crocker, 314 Ore. at 131-32.

The IITA solves the apportionment problems presented by such situations by preventing the combination of financial organizations and non-financial organizations. 35 **ILCS** 5/1501(a)(27). TAXPAYER's subsidiaries, however, are not members of a regulated financial industry, and are not engaged in a business distinct or independent from the business of the unitary group. Arguing that the Director should use the same factor representation apportionment method the Oregon Supreme Court allowed to be used by a member of a regulated financial industry in Crocker is but TAXPAYER's final attempt to have the Department treat its subsidiaries as something they are not. I recommend that the Director deny TAXPAYER's request to include the value of the securities held by its subsidiaries in the denominator of the property factor.

Finally, WITNESS E testified that he always had a knee-jerk reaction against any proposal to assess tax intangible property as business income. Tr. 10/11 pp. 58-59. Moreover, WITNESS E admitted that, when measuring the property factor regarding TAXPAYER's business activities in Illinois, he was most concerned with increasing the numbers to be included in the denominator of the apportionment fraction. *See* Tr. 10/11 p. 147 (WITNESS E). WITNESS E's admitted bias does not support the reliability of his alternative apportionment proposals in this matter.

As the Illinois Supreme Court has noted, the legislature has established the three factor formula as the presumptively fairest method of apportioning business income. *See* Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102, 124 ("we consider the overall design of section 304 is calculated to determine that amount of business income fairly attributable to Illinois"). That is the method used by the Department's auditor in this matter. Creating a formula which results in a lower amount of taxable income does not support a claim of distortion where the alternative methods proposed do not reflect the unitary business group's actual use of the assets from which the income flowed. TAXPAYER introduced no evidence which tended to establish that the methods proposed by WITNESS E more properly measured the business income attributable to the operations of TAXPAYER's unitary business in Illinois.

Conclusion To Part 2 of Recommended Decision

I recommend that the Director deny the alternative apportionment methods proposed by TAXPAYER.

Date

Administrative Law Judge